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An Analytical Study of Islamic Finance Development In Southeast Asia

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Abstract:

This study analyzes the development of Islamic finance volume in Southeast Asian countries amid the transition toward the digital economy during the period 2017–2022. A descriptive approach was used for the theoretical framework, while an analytical approach was adopted to examine data collected from various reports on Islamic finance.

The results reveal significant growth in the Islamic finance sector, particularly in Malaysia and Indonesia. Supported by digital transformation, government initiatives, and increasing awareness, the sector is expected to continue expanding and play a stronger role in the regional digital economy.

Keywords: Islamic Finance, Southeast Asia, Financial Development, Digital Transformation.

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1. INTRODUCTION:

Finance, in all its forms and types, has become the driving force of digital economic activity in any economic system and the largest contributor to its added value, as it serves as the primary aggregator and distributor of funds through financing various economic activities. It is clear that the digital economy represents a significant opportunity for achieving sustainable economic growth through the use of modern technologies. However, this requires proper preparations at the level of infrastructure, education, and public policies to support this transformation.

Thus, Islamic finance today is growing at a good pace due to the contribution of global market fluctuations, which have tested the efficiency of Islamic financial institutions and their products. Islamic finance is a type of financing derived from the principles of Islamic law (Sharia), which aims at achieving justice and social solidarity. The fundamental principle on which this financing system is based is the prohibition of *riba* (usury), along with profit and loss sharing, in addition to other principles that have all been tested through the scale of logic and reason. Thanks to these distinctive characteristics and principles, Islamic finance has managed to establish itself in Southeast Asian countries, extending beyond Islamic nations to even non-Islamic countries and international financial institutions.

1-1 Research Problem:

Given the interest of many economic researchers in the necessity of Islamic finance as the optimal means to achieve fairness in financing productive investments in various countries, the research problem has been formulated around a main question, which is:

How has the size of Islamic finance developed in Southeast Asian countries?

1-2 Study Hypotheses:

In order to further explore the research problem and provide an answer, the study hypothesis is framed as follows:

- The size of Islamic finance in Southeast Asian countries has positively developed during the study period, due to the enhancement of its global position, the expansion into international markets, and the ability to create a dynamic supportive environment capable of overcoming all challenges that hinder the development of Islamic finance.

1-3 Study Objectives:

This study aims to illustrate the development of the size of Islamic finance in Southeast Asian countries during the period from 2017 to 2022. It also highlights the importance of resorting to Islamic finance due to its positive impact on achieving economic development and overcoming the challenges that affect and hinder the traditional banking sector, which is based on interest-based financing.

1-4 Study Methodology:

In order to answer the proposed research problem and address the elements of this study, the descriptive approach was relied upon in the theoretical aspect. As for the practical aspect, the analytical approach was used by collecting data related to Islamic finance in Southeast Asian countries from various reports and analyzing them.

2. A General Conceptual Reading on Islamic Finance:

Among the most important fundamental topics in Islamic economics in general and Islamic finance in particular, we find Islamic finance. This will clarify some basic concepts about this important and complex subject:

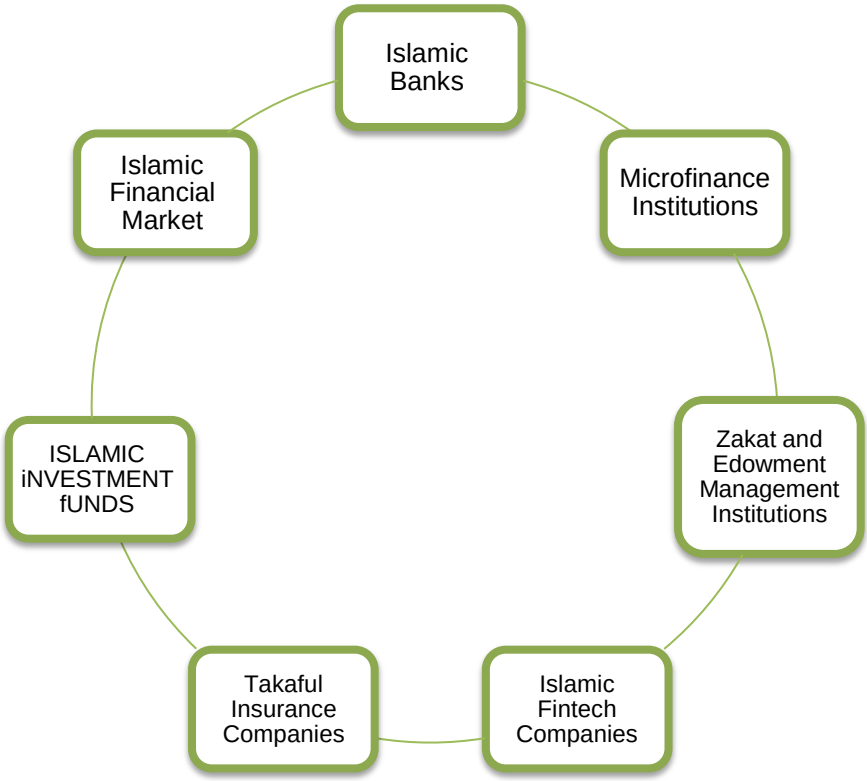
2-1 The Concept of Islamic Finance

The concepts of Islamic finance have varied and differed from one researcher to another and from one entity to another. Among the most prominent of these concepts, the following can be distinguished:

- Islamic finance is the trust that an Islamic bank places in its client by providing a specific amount of money to be used according to a specific Sharia-compliant structure for a defined purpose and within a specified time frame. The transaction is conducted under agreed terms in exchange for a mutually agreed financial return **Source spécifiée non valide.**
- Islamic finance is based on a legal principle that profits are earned through ownership or labor. It is a form of financing that primarily relies on ownership for profit and is based on the absence of usurious interest. Islamic finance structures vary according to the level of authority held by the financier and the rights and obligations resulting from this. There are structures in which the decision-making power lies solely with the business owner, without the intervention of the financier, while there are other structures where the decision-making authority is shared between the financier and the workers **Source spécifiée non valide.**
- Dr. Mohammed Al-Beltaji defines it as the provision of financial or non-financial support to various enterprises through structures that align with the provisions and principles of Islamic law, and according to legal and technical standards and controls, to play an active role in achieving economic and social development **Source spécifiée non valide.**.

In conclusion, Islamic finance can be defined as the provision of financial or non-financial support to individuals, businesses, and other entities in need of financing through various financial instruments and mechanisms that comply with the principles of Islamic Sharia law. This financing is provided under specific contractual arrangements and conditions, in exchange for an agreed and Sharia-compliant financial return. Islamic finance is generally offered through specialized financial institutions that mobilize and allocate financial resources according to Islamic principles. (Rahma, 2020 p. 299).

Figure 1. Islamic Finance Institutions



Source: Prepared by the researcher based on several references

Islamic finance in Islamic banks is based on principles, the most important of which are as follows **Source spécifiée non valide.**:

a) **Adherence to Sharia guidelines in financial transactions**: This is achieved through the following:

- Prohibition of usury (Riba);
- Prohibition of hoarding;
- Investment of money in permissible (halal) activities and avoiding prohibited (haram) ones;
- Adherence to ethical standards in financial transactions.

b) **Adherence to the principle of "Revenue follows the guarantee, and loss follows the gain":** "Gain" refers to profit, and "loss" refers to loss. This principle means that an individual must bear responsibilities and burdens in proportion to the benefits and rights they receive. The burdens are to be distributed fairly and equitably, ensuring balance between duties and rights. One side should not be burdened at the expense of the other. For instance, a small or medium-sized enterprise that seeks to make profits must also be willing to share in the losses, if any. The agreement should specify the percentage, which must be the same in both cases of profit and loss.

c) **The Principle of Continuity of Ownership for the Owner:** This principle asserts that ownership in Islamic finance remains with the owner even if the form of ownership changes. Typically, the financing is in the form of cash, which is used to purchase investments and properties necessary for starting a project. The owner of the capital is entitled to the profit generated as a result of their investment.

d) **The Principle of Linking Financing to the Physical Aspect of the Economy:** Islamic finance is closely linked to the physical aspect of the economy. It is not based solely on the beneficiary's ability to repay, but rather on a specific investment project that has been studied for its feasibility and expected outcomes. Both the financier and the beneficiary agree to this study before establishing the financing relationship between them. Additionally, Islamic finance is a phenomenon that is tied to the production cycle of goods and services. Financing increases or decreases

in accordance with the needs of the production cycle for financial elements, making it a real phenomenon in the economy. In contrast, usurious financing is purely a financial phenomenon.

2-2 Islamic Financing Contracts

Islamic finance includes many contracts, and among these, they can be presented along with their definitions in the table below.

Table 1. Islamic Financing Contracts

Islamic Financing Contracts	Concept
Mudarabah	It is a contract between two parties or a partnership between two individuals. The first participant is the owner of the capital, who contributes with his money, while the second participant is the "Mudarib," who contributes with his effort, expertise, and management. The profit is shared between them based on the agreed-upon percentage. However, the Mudarib only shares in the profit, and in case of a loss, while the Mudarib bears the loss of his effort and work, provided that he did not violate the conditions set by the capital owner. If the Mudarib violates these conditions, he becomes obligated to compensate for the loss, i.e., to return it. The Mudarabah contract includes several types, such as: bilateral Mudarabah, collective Mudarabah, unrestricted Mudarabah, and restricted Mudarabah. This important Islamic financing mode is widely employed across various vital sectors, including the commercial, real estate, and agricultural sectors. (Noureddine, et al., 2020 p. 250)
	It is a contract between two partners, where the first partner is the bank, which participates with the client in their economic activity or project by providing the financing requested by the client without a specified interest rate. The second partner is the client, who contributes a certain share of the total financing for the project. The client may also take responsibility for managing the project and overseeing

Musharakah	its implementation if they have the necessary skills and expertise. The partnership contract includes agreed-upon distribution ratios for the project's returns or activity, whether profit or loss. The financing through participation is divided into two types: fixed participation and decreasing participation ending with ownership.
Salam sale	Salam is a sale contract in which the price is paid in full at the time of the agreement, while the delivery of the purchased goods is deferred to a specified future date. (Al-Hanawi, 2001 p. 72) Islamic Sharia has permitted this type of transaction in various circumstances because it enables buyers to secure goods in advance while providing sellers with immediate access to funds. Furthermore, Salam contracts help avoid interest-based transactions (riba), thereby ensuring compliance with the principles and requirements of Islamic law.
Murabaha	Is a type of sale in which a financial institution (such as banks, financial institutions, etc.) purchases a specific good needed by a client based on a market study or a promise to purchase made by the client. The client requests the financial institution to buy a certain good or import it from abroad, expressing their intention to repurchase it from the financial institution. If the financial institution agrees that there is a market need for the good and proceeds to purchase it, it can sell the item back to the original buyer or to someone else at a profit. The financial institution discloses the purchase price, including the associated costs, and adds a specified profit margin to the price for the buyer. The sale price is then agreed upon, and the place and terms of delivery, along with the payment method, are established. This type of transaction is based on the Islamic principles of transparency and fairness, ensuring that both the buyer and the seller are fully aware of the costs and profit involved in the deal.

Musaama	(Bargaining Sale) is a sales contract through which a bank sells a specific good, either movable or immovable property, to a client at a fixed price agreed upon at the time of the transaction.
Ijarah	Is a contract for the lease of a permissible benefit, which is specified in terms of duration, the object of the lease (whether tangible or described in the liability), or the work being provided, for a known compensation. Contemporary examples of **Ijarah** include **operating leases**, where Islamic banks lease equipment or properties to investors according to their needs for a certain period, maintaining ownership with the bank while the lessee enjoys the use of the asset.
Istisna'a	Is a contract in which the client (the financing seeker) requests the bank to manufacture a specific product using raw materials provided by the bank, according to certain specifications, and for a price agreed upon in advance. It is a contract for the sale of a manufactured item, where the seller is the manufacturer who commits to producing the specified item as described in the contract using the materials provided by the bank. The agreed price for the final product is clearly defined. This type of contract is commonly used for manufacturing goods, construction, or custom orders, where the buyer has specific requirements. It complies with Islamic finance principles as it avoids interest-based transactions and ensures transparency regarding the manufacturing process and pricing.

Source: Prepared by the researcher based on several references.

3. Analysis of the Reality of Islamic Finance in Southeast Asian Countries:

Islamic finance has developed worldwide in various forms and methods offered through different institutions. Southeast Asian countries have experienced significant growth in the past two decades, thanks to a combination of economic, social, and legislative factors that have supported its development in this region. Countries such as Malaysia, Indonesia, Brunei, and Singapore are among the leading centers that have witnessed substantial growth in this field. From the table shown below, we can observe a clear increase in the reliance of Southeast Asian countries on Islamic banking assets, Islamic sukuk, Islamic fund assets, and Islamic takaful between the years 2017-2022.

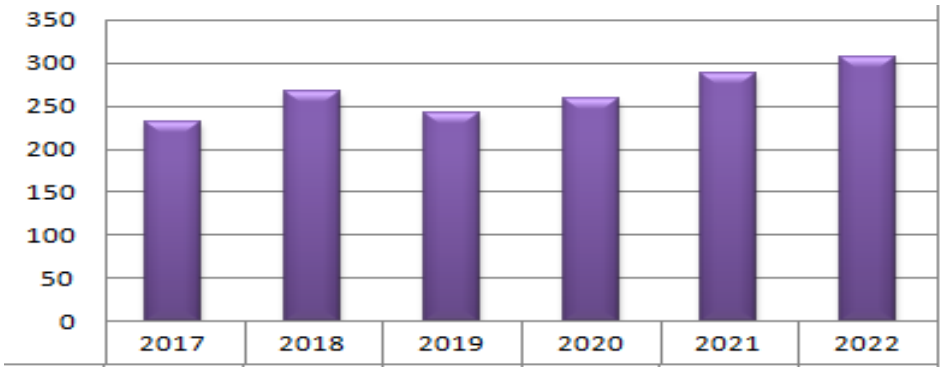
Table 2. Development of the Size of Islamic Finance in Southeast Asian Countries (Billion USD

The components of Islamic finance	2022	2021	2020	2019	2018	2017
Assets of Islamic Banks	307.2	287.5	258.2	240.5	266.1	232.0
Islamic Sukuk	411.4	390.3	366.4	303.3	323.2	239.5
Islamic Investment Funds	32.8	37.5	41.9	26.7	24.2	24.8
Islamic Takaful	6.0	4.7	4.1	3.02	4.1	3.3

Source: Prepared by the researcher based on **Source spécifiée non valide.**

It can be observed from the table above that the size of Islamic finance in Southeast Asian countries has been continuously and significantly developing during the period between 2017 and 2022. Islamic finance consists of Islamic banking assets, Islamic sukuk, Islamic fund assets, and Islamic takaful. From this, we can analyze the development of Islamic banking assets in Southeast Asian countries, whose primary function is to accept deposits based on loan contracts, deposit contracts, or profit-sharing contracts, and utilize them through Islamic financing contracts, as shown in the graph below.

Figure 2. Development of Islamic Banking Assets in Southeast Asian Countries (Billion USD)

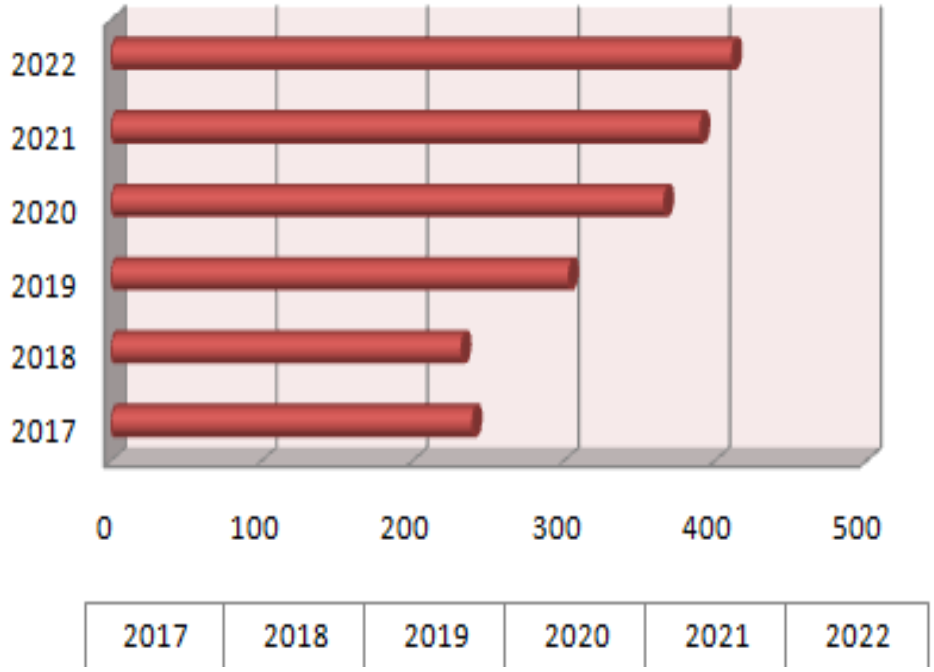


Source: Prepared by the researcher based on **Source spécifiée non valide.**

It can be observed from the graph above that the development of Islamic banking assets in Southeast Asian countries reached a value of 232 billion USD in 2017. This figure rose to 266.1 billion USD in 2018, then decreased by 25.6 billion USD in 2019 compared to 2018. However, it began to rise again in 2020 and 2021, increasing steadily to reach its highest value in 2022, which was estimated at around 307.2 billion USD.

The graph below represents the development of Islamic sukuk in Southeast Asian countries, which are among the most important products of the Islamic financial industry, as they are a distinguished tool that successfully combines the proper application of Islamic financing contracts with the modern requirements of project financing. This can be represented as follows:

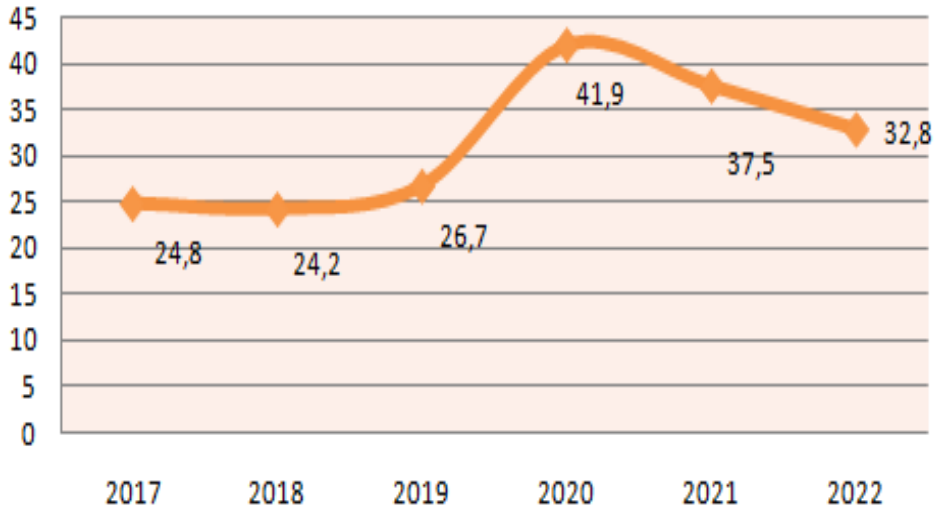
Figure 3. Development of Islamic Sukuk in Southeast Asian Countries (Billion USD**)**



Source: Prepared by the researcher based on **Source spécifiée non valide.**

It can be observed from the graph above that the development of the size of Islamic sukuk in Southeast Asian countries reached a value of 239.5 billion USD in 2017, then decreased to 232.2 billion USD in 2018. It rose by 71.1 billion USD in 2019 compared to 2018 and continued to rise steadily in 2020 and 2021, reaching its highest value in 2022, which was estimated at around 411.4 billion USD. The graph below represents the development of the size of Islamic fund assets as follows:

Figure 4. Development of Islamic Fund Assets in Southeast Asian Countries (Billion USD)

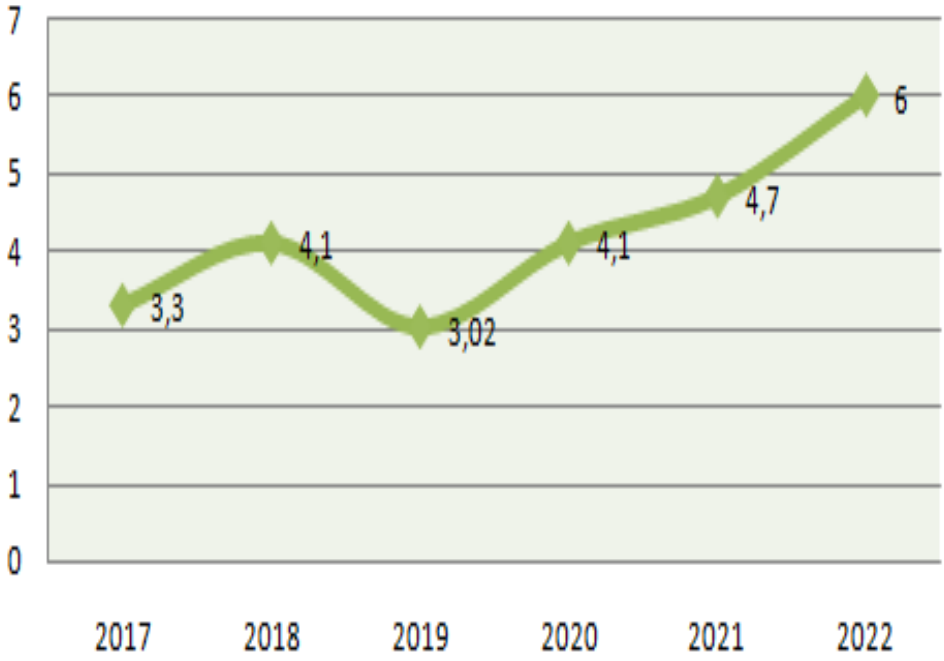


Source: Prepared by the researcher based on **Source spécifiée non valide.**

It can be observed from the graph above that the development of the size of Islamic fund assets in Southeast Asian countries reached a value of 24.8 billion USD in 2017, then decreased to 24.2 billion USD in 2018. It increased by 2.4 billion USD in 2019 compared to 2018 and continued to rise steadily, reaching its highest value in 2020, which was estimated at around 41.9 billion USD. However, it declined in 2021 and 2022, reaching values of 37.5 billion and 32.8 billion USD, respectively.

The graph below represents the development of the size of Islamic takaful in Southeast Asian countries, which is based on the principle of commitment but is more comprehensive, as it can cover all types of insurance and all societal needs. This can be represented as follows:

Figure 6. Development of Islamic Takaful in Southeast Asian Countries (Billion USD)



Source: Prepared by the researcher based on **Source spécifiée non valide.**

It can be observed from the graph above that the development of the size of Islamic takaful in Southeast Asian countries has shown continuous fluctuations during the period from 2017 to 2022. It reached a value of 3.3 billion USD in 2017, then rose to 4.1 billion USD in 2018. In 2019, it decreased to 3.02 billion USD, and then continued to rise steadily, reaching its highest value in 2022, which was estimated at around 6 billion USD.

4. Conclusion

After studying and analyzing the development of Islamic finance in Southeast Asian countries during the period from 2017 to 2022, it has become clear that the size of Islamic finance in this region has significantly grown. Countries like Malaysia and Indonesia have made notable progress in this sector. With increasing government support, digital transformation, and growing awareness, this sector is expected to continue growing, becoming an essential part of the regional digital economy.

4-1 Study Results:

Among the most important results reached by this study are as follows:

- Islamic finance is a type of financing that involves providing financial resources for any economic activity in compliance with Islamic law (Shariah).
- Islamic finance, through the digital economy, contributes to enhancing financial inclusion, as it provides financial solutions for individuals who cannot access the traditional banking system, enabling them to develop their businesses and financial resources in ways that align with Sharia principles.
- Islamic finance and the digital economy share several aspects, particularly in innovation and technology, which are key elements in the development of the financial system.
- The digital economy places technology in various forms at the service of the international financial system and humanity, focusing on prioritizing human resources by instilling concepts of innovation and creativity.
- The tools and products of Islamic finance vary depending on the type of assets these tools represent. These assets could be tangible goods, benefits, or debts.

- The digital economy, through its technologies, has contributed significantly to addressing many of the issues related to the Islamic financial and banking system.
- Islamic finance can spread widely in Southeast Asian countries despite the obstacles it has faced, and it is no longer limited to Islamic countries only.
- There has been an increased global interest in Islamic finance tools such as Islamic takaful, Islamic funds, and Islamic sukuk, and it is expected that these tools will witness even wider spread in the future.
- Southeast Asia accounted for the largest share of Islamic fund assets in the world in 2022.
- South Asia has taken the largest share of Islamic sukuk in the world, followed by the Gulf Cooperation Council (GCC) region, then Southeast Asia, and finally Africa and most other countries.

4-2 Study Recommendations:

This study resulted in a set of recommendations, among the most important of which are the following:

- Efforts should be made to raise cultural awareness about Islamic finance worldwide.
- It is essential to have a clear regulatory framework for digital financial activities that comply with Islamic law (Shariah).
- It is important to provide educational and training programs to familiarize professionals and investors in the digital economy with Islamic financial concepts and how to integrate them into digital financial services.
- Innovation in Islamic digital finance platforms should be supported.
- There is a need to open more specializations in Islamic finance to build the necessary competencies in this field.

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