Regulatory issues inhibiting the financial inclusion: a case study among Islamic banks and MSMEs in Indonesia

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Abstract

Purpose – The primary objective of this study aims to intensively explore the environment of Indonesian regulations and laws related to the Islamic banking system and micro-, small- and medium-sized enterprises (MSME) and unveil the restrictive laws and regulatory flaws that potentially hinder the Islamic banking institution and MSME industry in achieving financial inclusion and promoting sustainable growth.

Design/methodology/approach – This paper implements a qualitative method by implementing a multi-case study research strategy, both from the Islamic banking institutions and the MSME industries. The data were gathered primarily through an interview approach by adopting purposive uncontrolled quota sampling.

Findings – The findings of this paper reveal two essential issues: First, the regulatory imbalances and restrictions could demotivate and hinder the efforts of Islamic banks in providing access to finance for the MSME segment, hence, encumbering the achievement of the financial inclusion agenda from the Islamic banking industry. Second, the flaws in MSME registration and taxation might discourage the formal MSMEs from extending their business license and prevent the informal MSME units from registering their business. This issue would potentially lower their chance of accessing external financing from the formal financial institutions and participating in supportive government programmes due to the absence of proper legality.

Research limitations/implications – Since this paper only observed six Islamic banks and 22 MSME units in urban and rural locations in Indonesia using a case study approach, the empirical findings and case discussions were limited to those respective Islamic banks and MSME participants.

Practical implications – By referring to the recommendations as presented in this paper, two critical policy implications could be expected from adopting the proposed recommendations, among others: By addressing the issues of the regulatory imbalance associated with the Islamic banking industry and introduce the deregulatory policies on profit and loss sharing (PLS) scheme implementation, this approach will motivate the Islamic banking industry in serving the MSME sector better and provide greater access to financial services, particularly in using the PLS financing schemes. By resolving the problems on MSME registration and taxation, this strategy will enhance the sustainability of the formal MSMEs' operation and encourage the informal ones to register, hence, improving their inclusion into the formal financing services and government assistance programmes.

Originality/value – The present study attempts to address the literature shortcomings and helps to fill the gaps – both theoretical and empirical – by incorporating the multi-case study among Indonesian Islamic banks and MSMEs to extensively explore the Indonesia regulatory environment pertaining to the Islamic banking system (supply-side) and MSMEs (demand-side), and thoroughly investigates and reveals the restrictive laws and regulatory flaws that could potentially hinder the Islamic banking institutions and MSME industries in attaining financial inclusion and contributing to sustainable development.

Keywords Financial inclusion, Indonesia, Islamic bank, MSME, Regulation

Paper type Case study

JEL classification – G21, G40, O17

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1. Introduction

The notion of an inclusive financial system has evolved significantly since its beginning, once perceived as a medium to reduce poverty and lessen income inequality in the nation. Later, this concept developed into critical requirements for economic development and financial stability. Financial inclusion allows producers and household to boost their production and consumption of goods and services through which income is created in the economy. Hence, this concept generates more income by augmenting the productive capacity, particularly for those with no assets to start with and facilitates inclusive growth. Furthermore, in an inclusive financial sector environment, better institutional quality could facilitate efficient intermediation and enhance economic performance (Mathur and Marcelin, 2015; Marcelin *et al.*, 2022). Besides, previous studies also documented the link between governance and economic development and maintained that vital institutions foster economic well-being (Keefer and Knack, 1997; Acemoglu *et al.*, 2001; Mathur and Marcelin, 2015). In other words, the regulatory systems, the government bodies, the banking industries and the demand-side sectors play a crucial role in promoting financial inclusion, and they need to interact seamlessly to stimulate sustainable growth and economic stability.

The Islamic banking industry, as the important core of the Islamic financial institution in Indonesia, plays a critical role in promoting the success of the Islamic financial inclusion agenda by providing quality financial products, giving easy access, and ensuring the efficient and effective allocation of these financial services to their customers. On the other side, the micro-, small- and medium-sized enterprises (MSME) segment has a considerable impact on Indonesia's sustainable economic development. The Indonesian government frequently acknowledges the MSME sector as a vital engine for job creation and critical reinforcement for economic growth. MSME industry also contributes significantly to the gross domestic product of the country and ensures a proper flow of money across Indonesia's economy (IFC, 2016; MoCSME, 2017; OECD, 2018; ILO, 2019). Nevertheless, to promote the effectiveness of the financial inclusion process, both the Islamic banking sector and the MSME industry must be accompanied by supportive laws, regulations and policies that could facilitate access to financial products and services. Previous literature shows the evidence of a positive relationship between financial inclusion and enhanced legal rights as well as politically stable environments (Allen *et al.*, 2016; Ahamed and Mallick, 2019; Marcelin *et al.*, 2022). Nevertheless, in developing countries, particularly with weak institutions (Demetriades and Hook Law, 2006), poor competition (Rajan and Zingales, 2003), and high inflation (Rousseau and Wachtel, 2002), these aforementioned problems will hinder the finance-induced economic benefits (Marcelin *et al.*, 2022). Unfortunately, despite the vital position of MSMEs for Indonesia's sustainable economy, many MSME industries are facing challenges and issues that hamper their development and limit their contribution to the country's economic growth. The earlier industrial reports disclosed that the primary constraint faced by the MSME segment and hindering their growth is access to finance (Irjayanti and Aziz, 2012; IFC, 2016; ILO, 2019), and the regulatory environment becomes one of the critical factors that constraints the banking institutions' manoeuvres in serving the MSME needs and limits the MSME access to financial services; thus, hindering the sector's growth (Rosengard and Prasetyantoko, 2011).

Although there are substantial reports and studies that explore and document the condition of the banking industry and MSME in Indonesia in regard to financial inclusion (IFC, 2016; OJK, 2017; OECD, 2018; ILO, 2019; KNEKS, 2020); nonetheless, there is lack of in-depth discussion and exploration pertaining to the regulatory issues that inhibit the financial inclusion both from the banking sector and MSME segment in Indonesia (Rosengard and Prasetyantoko, 2011; Irjayanti and Aziz, 2012; IFC, 2016; ILO, 2019), and even scarcer in the context of the Islamic banking industry (Huda, 2012; Yustiardhi *et al.*, 2020). Subsequently, from the theoretical perspective, despite the vast theoretical literature that emphasises on the inclusive and developed financial system and their positive correlation to overall economic development (Mathur and Marcelin, 2015; Allen *et al.*, 2016; Kim *et al.*, 2018; Ahamed and Mallick, 2019: Haini, 2020; Marcelin *et al.*, 2022); however, there is lack of extensive discourse in regard to the theoretical linkages in the regulatory setting from the perspective of both Islamic banking sector and MSME segment, particularly from the Islamic financial inclusion standpoint (Saifurrahman and Kassim, 2023).

Therefore, this study attempts to address the abovementioned literature shortcomings and helps to fill those gaps – both theoretical and empirical – by incorporating the multi-case study among Indonesian Islamic banks and MSMEs to thoroughly explore the environment of Indonesian regulations and laws related to the Islamic banking system and MSME. Besides, this study also tries to reveal the restrictive laws and regulatory flaws that potentially hinder Islamic banks and MSMEs in achieving financial inclusion and promoting sustainable growth. Moreover, the present study also investigates the perception of Islamic banks and MSME entrepreneurs regarding the regulatory requirements and how they behave to address these regulatory challenges to sustain their operation and attain MSME Islamic financial inclusion and eventually discusses the findings with the associated theories and how these theories interrelated with the current study's analysis and empirical results. From the aforementioned research objectives and literature review discussion, there are at least two research questions that could be derived from the earlier aspects:

RQ1. How will the restrictive regulatory environment affect the Islamic banking industry in serving the MSME segment to achieve financial inclusion?

RQ2. How will the flaws in regulation influence the behaviours of MSMEs in embracing financial inclusion and accessing Islamic financial services?

The results and analysis of the current study indicate two critical issues. Firstly, the regulatory imbalances and restrictions could demotivate and hinder the efforts of Islamic banks in providing financial services for the MSME segment, therefore, constraining the achievement of the financial inclusion agenda from the Islamic banking industry. Secondly, the flaws in MSME registration and taxation could discourage the formal MSMEs from extending their business license and prevent the informal ones from registering their business. This problem would consequently reduce their chance to access external financing from formal financial institutions and to participate in subsidised government programmes due to the absence of proper business legality.

The remainder of the paper is structured as follows. Section 2 reviews the existing literature pertaining to the theoretical underpinning related to financial inclusion and its supportive environment, the regulatory overview of MSME credit and financing in Indonesia, enabling law for MSME growth, other laws supporting MSME financial inclusion, and regulatory factors inhibiting MSMEs' financial inclusion. Section 3 explains the methodology used to achieve the objective of the study and discloses the list of participants from the Islamic banks and MSMEs. Section 4 provides the findings and discussions from the side of Islamic banks and MSMEs, as well as disclosing the research implications and recommendations to address the regulatory issues. Section 5 summarises the key findings, mentions the limitation of the study and elaborates on the extension for future research.

2. Literature review

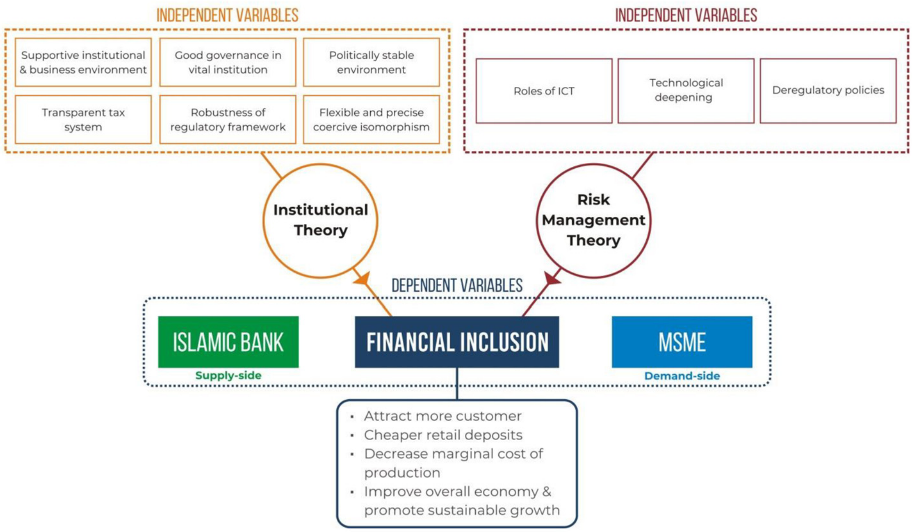
2.1 Financial inclusion and supporting environment: a theoretical consideration

Previous research suggests that in countries with an inclusive financial sector, the banking institutions will have a more substantial presence across the country's regions to reach all segments of customers in their diversified group and background, which, in turn, improves the economy's overall performance. In this regard, the banking industries will distribute financial facilities, such as financial products, branches and automatic teller machines (ATMs), more equitably within the constituents. The benefits of a more inclusive financial sector outweigh its costs, and when the banks operate in a financially inclusive environment, they will attract more nearly risk-free and cheaper retail deposits and decrease their marginal costs of production (Ahamed and Mallick, 2019; Marcelin *et al.*, 2022). Furthermore, the institutional environment in which the banks operate may alleviate transaction costs and augment their way of doing business (Williamson, 1996; Marcelin and Mathur, 2014; Mathur and Marcelin, 2015). Keefer and Knack (1997), Acemoglu *et al.* (2001), as well as Mathur and Marcelin (2015), documented the link between governance and economic development and suggested that more vital institutions will boost economic well-being. Besides, there is evidence of a positive relationship between financial inclusion and enhanced legal rights as well as politically stable environments, suggesting that a stable regulatory environment will promote and strengthen financial inclusion (Allen *et al.*, 2016; Ahamed and Mallick, 2019; Marcelin *et al.*, 2022). Nevertheless, in developing countries, particularly with weak institutions (Demetriades and Hook Law, 2006), poor competition (Rajan and Zingales, 2003) and high inflation (Rousseau and Wachtel, 2002), these issues will hinder the finance-induced economic benefits (Marcelin *et al.*, 2022). Subsequently, the theoretical research emphasised on institutional theory also suggested that a robust regulatory framework is obligatory to attain financial inclusion (Figart, 2013). Besides, flexible and precise coercive isomorphism could elevate both the supply and demand-side chances to promote financial inclusion and achieve sustainable economic development (Seman, 2016; Saifurrahman and Kassim, 2023).

From the MSME perspective, the earlier literature also implies that an economically sound, stable and business-friendly atmosphere will consequently foster investment, promote entrepreneurship and stimulates MSME sector development and activities. The robustness of the legal and regulatory framework, restructuring and resolution mechanism, stable and transparent tax framework and availability of financing options are considered enabling factors to foster MSMEs' growth (Atkinson, 2017; Saifurrahman and Kassim, 2021). In this concern, while the regulation intends to remedy market failures, reduce information asymmetries and strengthen the balance between the goals of different stakeholders, regulatory constraints and barriers could pose a hindrance for the business, particularly the MSME segment. The complex regulatory framework and complicated administrative and bureaucratic procedures create a burden and result in additional costs for enterprises to enter the market. Such aforementioned costs are significantly higher for the micro and smaller segment of enterprises since regulation typically entails a fixed cost. Hence, with no dedicated personnel nor resources to deal with the regulatory requirements, the entrepreneur may end up reallocating the effort and time needed to manage the business to handle the regulatory burden (Nassr *et al.*, 2016; Saifurrahman and Kassim, 2021).

Moreover, risk management theory pertaining to financial intermediation considers how technological deepening may lessen the issue of asymmetric information and transaction cost in lending and borrowing relationships (Allen and Santomero, 1997). Scholtens and Van Wensveen (2003) further support the earlier theory that financial sector reforms and technological advancement could contribute to the elimination of information asymmetry problems and transaction costs. Subsequently, mature economies typically embedded technology and implemented deregulatory policies to address structural constraints, and information and communication technology (ICT), which depend on sturdy telecommunications infrastructure, could facilitate economic growth by increasing productivity, decreasing transaction cost, encouraging innovation and promoting overall development, which includes financial sector (Chatterjee, 2020; Wellalage *et al.*, 2021). In this respect, digital technologies are the enablers for entrepreneurial activity (von Briel *et al.*, 2018), and this manifested in numerous forms ranging from digital products and services (Lyytinen *et al.*, 2016), digital artefacts (Ekbia, 2009), digital platforms (Tiwana *et al.*, 2010) and internet-based service innovations (Kuester *et al.*, 2018). Furthermore, according to Freixas and Rochet (2008), technology might reduce transaction costs and even the ex ante event of asymmetric information (adverse selection). In addition, ICT could also reduce information opacity (Scholtens and Van Wensveen, 2003), a characteristic of most MSME industries that typically makes them appear less attractive compared to the larger firms and more susceptible to the risk of financial exclusion (Dong and Men, 2014) (see Figure 1).

In general, a well-developed financial system indicates sound financial intermediaries and vice versa, which are ready to promote domestic investment, encourage foreign direct investment and boost economic growth (Kim *et al.*, 2018; Haini, 2020). Foreign direct investment transfers superior technology and managerial skills across regions and helps to preserve competitiveness (Sultana and Turkina, 2020). Later, as a secondary effect, financial development establishes demand for new infrastructure, easy access to funds and lower credit cost, which lifts economic activity, improves the labour participation rate, creates new employment opportunities and expands markets (Aghion *et al.*, 2018). As suggested by Prochniak and Wasiak (2017), a sound financial sector will protect an economy from shocks, from within and without, thus, promoting macroeconomic efficiency (Asteriou and Spanos, 2019; Hunjra *et al.*, 2022). The previous narrative operates via two channels. Firstly, lower



Source: Authors' own

Figure 1. Theoretical framework

credit cost could stimulate entrepreneurial talent (Dutta and Meierrieks, 2021), which inevitably promote industrial growth and enhances overall welfare. Secondly, credit availability enables investment in human capital formation, which is the critical component for innovation, technological advancement and economic development (Qamruzzaman *et al.*, 2021; Hunjra *et al.*, 2022). According to Levine (2005), financial development promotes productivity by making information available, which translates to lower transaction costs and enhances the decision-making process, and therefore, supports growth.

2.2 Regulatory overview of micro-, small- and medium-sized enterprises credit and financing in Indonesia

Numerous studies and reports are disclosing the critical role of MSMEs in Indonesia's sustainable economic development and how the growth of this essential sector could potentially assist the country in alleviating poverty, providing job opportunities, reducing income disparity and amplifying foreign exchange revenues (IFC, 2016; Dwi, 2017; MoCSME, 2017; Incubator, 2018; ILO, 2019; KNEKS, 2020). Hence, due to this MSME's vital position, the Government of Indonesia introduced specific laws and regulations to promote the growth and development of the MSME segment. Since 2004, the government has strategically promoted MSME as the engine of sustainable and pro-poor growth. In consultation with all the relevant ministries and agencies, the government launched comprehensive economic policy reforms called the new economic policy package in 2007 and 2008 (IFC, 2016). This package included policies to improve the investment environment, finance and infrastructure sector. The aim was to strengthen the MSMEs sector.

Subsequently, to encourage more access to credit/finance for MSMEs, the Government of Indonesia, represented by Bank Indonesia (central bank of Indonesia (BI)), issued the banking regulation No. 14/22/PBI (Peraturan Bank Indonesia)/2012 to support the MSME's credit and financing environment. The regulation was modified and updated later with the issuance of banking regulation No. 17/12/PBI/2015. This regulation was issued primarily to assist the MSMEs in obtaining access to finance due to its critical function and significant contribution to Indonesia's economic structures and act as an inflation management tool. This banking regulation covers the conventional and Islamic financial institutions that consist of commercial banks and other financial service providers (FSPs), such as microfinance institutions and *Baitul Maal wa Tamwil*. The regulation primarily obliges the financial institution to give access to credit for MSMEs, with the gradual minimum ratio requirement out of the total credit portfolio. In 2013 and 2014, the compulsory credit ratio followed the ability of FSPs to disburse credit to MSMEs. Later, in 2015, the minimum ratio was 5% out of total credit, while in 2016, the minimum ratio was 10%, and in 2017 the ratio was 15%, and finally, in 2018, all Indonesian FSPs were required to disburse up to 20% minimum credit ratio for MSME financing. Moreover, this credit disbursement could be given directly to the MSMEs by financial institutions or indirectly using the collaborative scheme through the "executing system" or "channelling system" or through the "syndication" method. Furthermore, for non-local banks, credit to export non-oil and gas could be counted and considered as MSMEs credit disbursement. Subsequently, the FSPs are also mandated to give special treatment and attention to the MSMEs located in the area affected by natural disasters (Bank Indonesia, 2012a).

Furthermore, to motivate and inflict disincentives for financial institutions serving the MSME sectors, the regulation stated that the Bank Indonesia might award the banks able to fulfil the minimum credit ratio for MSMEs financing and publish such achievements on the Bank Indonesia website. On the contrary, if the banks cannot attain such a required ratio, the banks are mandated to train the unbanked MSMEs that are not currently in loan or financing schemes. The training fund needs to be allocated with a minimum amount of 2% from the remaining credit ratio that has not been disbursed with the maximum amount of Indonesian Rupiah (IDR) 10 billion. Concerning the non-compliance with the mandatory requirements, as stated by Bank Indonesia regulation No. 14/22/PBI/2012, the Bank Indonesia may impose a penalty that consists of written warnings or reduce the bank's soundness level (Bank Indonesia, 2012b).

In 2015, the Bank Indonesia issued another regulation to amend and revise some of the terms and descriptions to make them more precise with the issuance of regulation No.17/12/PBI/2015. The newer regulation merely serves as the revision to the preceding regulation No. 14/22/PBI/2012 on MSME financing due to some updates in the terms and clauses (Bank Indonesia, 2015). The main distinctive point between the recent and the previous regulation is that:

- Commercial conventional banks are required to keep the achieved minimum credit ratio monthly.
- Commercial banks (conventional and Islamic) are obliged to submit a monthly report regarding MSMEs' credit/financing and include it in monetary stability and financial system reports through an online platform provided by Bank Indonesia.
- Inflict specific disincentives for Islamic banks for non-achievement of the minimum ratio of MSMEs financing as mandated by the regulation by providing the training programme for unbanked MSMEs and un-financed MSMEs.
- Implement a relief for the "conventional banks" regarding the loan-to-funding ratio or minimum reserve requirement in case of attainment in minimum credit ratio for MSMEs financing.
- Enforcing penalties for late reporting and non-reporting of MSMEs financing schemes and programmes and imposing a certain fine for such offences.

Additionally, to complement this newly issued regulation, Bank Indonesia issued a circular regulation No. 17/19/DPUM that altered the previously issued circular regulation No. 15/35/DPAU as complementary to the revised Bank Indonesia regulation No. 14/22/PBI/2012. The significant alteration provided by the recent circular is the inclusion of credit rating facilitation for MSMEs to reduce asymmetric information and enhance the disbursement of MSME credit/financing.

2.3 Enabling law for micro-, small- and medium-sized enterprises growth

Concerning the enabling law to support and protect MSMEs in Indonesia, the Government of Indonesia has already issued several regulations related to MSMEs since 1995. The most recent regulation issued by the government on MSME is Indonesian regulation No. 20/2008. This regulation repeals Indonesia regulation No. 9/1995 pertaining to small enterprises. The current regulation describes the definition of MSMEs, appends another micro-segment of enterprises and subsequently defines the criteria for each enterprise segmentations. Furthermore, the regulation covers several aspects to promote MSME growth and protect its business environment by addressing the provision of finance, means and infrastructures, business information, partnership, guarantee, business license, business opportunity, trading promotion and institutional support. In addition, the regulation protects the MSME atmosphere by strictly prohibiting the larger enterprises from monopoly and dominating the business environment (Indonesia regulation, 2008).

2.4 Other laws supporting the micro-, small- and medium-sized enterprises financial inclusion

Besides the financing and credit regulation for MSMEs and its enabling law, in 2016, the Government of Indonesia issued a regulation to support the achievement of financial inclusion by issuing the National Strategy for Financial Inclusion (Strategi Nasional Keuangan Inklusif/ SNKI) with Presidential Decree No. 82/2016. SNKI aims to improve the coordination among various government agencies and access to finance for Indonesian MSMEs (IFC, 2016), and this SNKI consists of six crucial pillars:

(1) *Financial education:* This pillar's objective is to promote finance competency by enhancing financial literacy and public awareness regarding financial services.

(2) *Financial facility for the public:* This pillar refers to the Indonesian government's ability to provide access to finance, directly or indirectly, to promote socio-economic empowerment.

(3) *Financial information mapping:* The objective is to increase the public capacity regarding their eligibility to become more bankable by the formal financial institution.

(4) *Supporting regulation and policy:* The aim is to increase access to financial products and services.

(5) *Intermediation facility and distribution channel:* The objective is to augment the FSPs' awareness regarding the potential public segments and search for alternate methods to expand the financial services distribution.

(6) *Consumer protection:* This protection intends to give the public peace of mind when interacting with FSPs in using the offered financial services (BPK RI, 2016; Bank Indonesia, 2023).

Furthermore, to increase the usage of movable collateral by MSMEs, the Ministry of Law and Human Rights issued a regulation (Permenkumham 9/2013) in 2013 that implemented the online registration for the Fiducia agreement. The Fiducia Act (No. 42/1999) covers movable assets that are tangible and intangible (receivable). The act stipulates that the object ownership could be transferred to the creditor, with the control of the object remaining with the debtor. With this regulation, the registration of the movable collateral is done through an online system that can be accessed by a notary public, eliminating the need to visit the Fiducia registration office. Through this online system, the certificate of Fiducia is also issued by the public (IFC, 2016).

Recently, the government has reduced the tax rate for MSMEs under the government regulation (No. 23/2018), which takes effect from 1 July 2018. The new "final tax" rate of 0.5% (down from 1%) applies to MSMEs with an annual gross turnover of no more than IDR 4.8 billion. The reduced tax aims to encourage MSMEs to register with the government and adopt a more formal operating status, thereby taking advantage of other facilities, such as training and better bookkeeping (ILO, 2019). Moreover, the government introduced the Online Single Submission (OSS) licensing system on 9 July 2018. The system is designed to reduce lengthy bureaucratic procedures and attract more direct investment to the sectors (ILO, 2019).

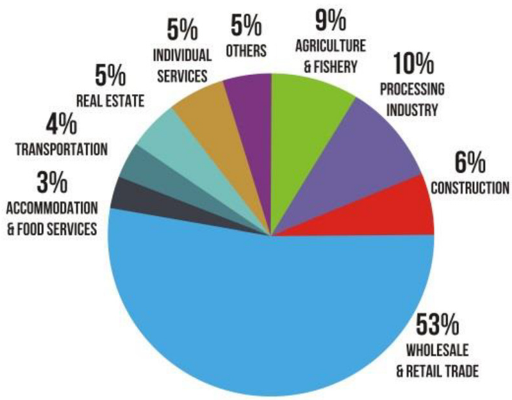
2.5 Regulatory factors inhibiting micro-, small- and medium-sized enterprises financial inclusion

After addressing the laws and regulations that support and protect MSMEs' environment for growth, we could observe that the Government of Indonesia have substantial incentives to develop this potential sector by issuing holistic regulations that provide them with easier access to finance, a competitive business environment, development support, as well as informational and facility provision. Nonetheless, even the comprehensive regulation still has its flaws, and for the case of Indonesia MSMEs, it is confirmed by the high number of unbanked MSMEs, MSMEs that stay informal and unlicensed, and the financial industry perception of the high-risk business nature of the MSME industry (IFC, 2016; OJK, 2017; OECD, 2018; ILO, 2019; KNEKS, 2020). This section elucidates the regulatory constraint that still inhibits the MSME sector's ability to obtain finance and the reason behind it.

As mentioned earlier, the financial industry was mandated to allocate a minimum of 20% of their total credit ratio for MSME credit facilities; this is indeed good news for MSMEs since this mandated ratio will give them a better chance of obtaining finance. However, according to the ILO (2019) report, the definition of this 20% credit allocation is vague and not entirely clear. The report stated that a large proportion of MSME financing and credit goes for trading purposes. Some of this credit and financing has been used for consumption and wholesale lending to the rural banks and development financial institutions, and not all financial institutions could give the financing for production purposes. In other words, the financing disbursement could be ineffective if it is merely focused on a specific area while the other potential areas are forgotten (Figure 2).

Besides, this minimum ratio is relatively high for smaller banking segments, and reports stated that some banks were struggling to achieve this minimum credit ratio (Sudarwan, 2018; Soemanagara, 2019). Furthermore, conventional banks are required to maintain their minimum credit ratio every month, as stated in the updated version of MSMEs financing regulation (Bank Indonesia, 2015); fortunately, the Islamic banks have no such requirement as it will be difficult for them due to the smaller customer size and market share compared to conventional banks.

Moreover, the focus on non-performing loans as interpreted in the newest version of Bank Indonesia circular No. 17/19/DPUM, and perceived limited flexibility is making some banks reluctant to lend to MSMEs, especially for high-risk or unbanked MSMEs, the consequences are that the client may be referred to a different financial institution with lower liquidity, or the financing is redirected by the banks to another bank product or exclusively allocated for existing client (ILO, 2019).



Source: IFC (2016)

Figure 2.
Share of sectors in MSMEs loan portfolios

Regarding the contradictive regulations, Rosengard and Prasetyantoko (2011) mentioned that adjusting reserve requirements and issuing Bank Indonesia's Bond has been the core of Bank Indonesia's practice to control inflation, and the bank has responded accordingly. It was mentioned that increasing the minimum ratio requirement might be good for monetary policy and bank profitability, but it has contributed to the crowding out of MSMEs' access to credit. The central BI tries to address these issues by updating the terms in the newest regulation of MSMEs financing by giving relief from minimum reserve requirements for the "conventional banks" that successfully achieve the minimum credit ratio for MSMEs. However, there is no such luxury for the Islamic banking segment in terms of relief from the minimum reserve if they could achieve the minimum credit ratio for MSME financing (Bank Indonesia, 2015).

It is important to mention that two main bodies regulate the Indonesian financial sector: BI, or the central BI and Otoritas Jasa Keuangan (OJK), or the financial service authority (ILO, 2019). Sometimes their regulation decisions led to inconsistencies. As mentioned by the IFC report (2016), small banks and microfinance institutions fall under the purview of OJK, whereas large banks are allowed to choose between the two regulators.

Additionally, the enabling law for MSMEs development states the simplification of the formalisation and licensing process to encourage the sector to be registered officially. However, in reality, many MSMEs are reluctant to be formally registered and opt for remaining hidden and informal. IFC (2016) reported that various permits and fees have been imposed mostly at the cost of sustainability and the growth of potential MSMEs. According to the MoCSME, around 400 local government regulations were potentially hindering MSME development as of August 2010. While applying for credit or financing facilities, banks require MSMEs to present their business registration and licenses. This license and registration is also a requirement of the government if businesses want to participate in specific government support programmes. Without a proper license, the enterprise runs the risk of being shut down. It was pointed out in the focused group discussion provided by the report that government officials regularly visit informal businesses and demand frequent payments for agreeing to overlook and ignore the missing license (IFC, 2016).

The reason many Indonesian MSMEs choose to stay hidden and informal is due to the fact that the procedure for registering a business is complicated and time-consuming (World Bank, 2014a). To establish a *Perseroan Terbatas*, the most common legal entity in Indonesia, an applicant must first apply through a public notary to the Ministry of Law and Human Rights for approval of the deed of establishment. Once the deed of the establishment has been approved, a Certificate of Company Domicile by the local government unit (*Lurah*) is needed. The next step is to apply for a Business Trading License (*Surat Izin Usaha Perdagangan*) from the relevant local government office (*Dinas*). Even more complex, the registration to the workers' social security programme is compulsory for businesses hiring more than ten employees or paying more than IDR 1 million per month in salaries. All businesses must also apply for health insurance with *Badan Penyelenggara Jaminan Sosial Kesehatan*. Eventually, a taxpayer registration number (Nomor Pokok Wajib Pajak/ NPWP) and value-added tax (VAT) collection number (Nomor Pokok Pengusaha Kena Pajak/ NPPKP) have to be obtained (IFC, 2016). In addition to the lengthy and costly registration procedure, taxes also discourage MSMEs from official registration. According to The Doing Business 2015 report, a standard medium-sized company will pay 31.4% of its profit in taxes and spend 253.5 h a year filing and paying taxes (World Bank, 2014b).

To solve the issues of MSME informality, ease enterprise registration, and encourage more businesses to enter the formal sector, the Government of Indonesia has been rationalising business licensing since 2010. Certain licenses have been phased out, fees reduced and the application process simplified. For example, trading licenses are now a part of the business registration process. Also, the country has introduced One-Stop-Shops (OSS) all over the country over the past years. Even though these have helped make it relatively easy to access information on business registration, The Asia Foundation, 2013 report stated that the procedures have remained complicated and difficult, it was confirmed by the report that many businesses (59%) still need assistance and hire agents to fulfil the formalities and documents, and informal payments remain common (54%) (Asia Foundation, 2013; IFC, 2016).

3. Methodology

This study was carried out by implementing a qualitative method and adopting a case study research strategy. The data was collected primarily through the interview by using purposive uncontrolled quota sampling from 28 July 2020 to 6 February 2021. The interview was administered using semi-structured interview questions by targeting the two sides of financial inclusion: supply-side and demand-side. The supply-side of financial inclusion was represented by the two segments of the Islamic bank industry in Indonesia, which consists of Islamic commercial banks and Islamic rural banks, by interviewing the heads of the MSME division, experts and directors of corresponding Islamic banks. On the other hand, the demand-side of financial inclusion was represented by the two MSME sector orientations situated in the urban and rural areas by interviewing the owners and the managers of the MSME units. Subsequently, the secondary data were obtained through literature, surveys, reports and internet materials.

Furthermore, this study uses an inductive approach to encapsulate diverse and extensive raw text data derived from the interview transcripts and secondary data into a brief and summary format, and to establish coherent relationships between the research objectives and the findings. Consequently, the inductive coding strategy was used to accommodate the inductive reasoning. Inductive coding refers to the data analysis process, in which the researcher reads and interprets raw textual data to develop themes, concepts or a model through interpretation based on the data (Corbin and Strauss, 1990; Boyatzis, 1998; Thomas, 2006). The inductive coding strategy begins with organising the raw data, which might come from the interview transcripts, academic articles, reports, news or other materials, via a process known as first-order coding or open coding. Through this process, the researcher closely analyses and reviews the data, makes notes and combines the data into broader themes and theoretical dimensions (Chandra and Shang, 2019). Moreover, this study also uses discourse and narrative analysis to address and investigate the common themes, concepts and issues that emerged from the research findings, and the analysis and coding procedures were assisted using Atlas.ti 8.0 for data classification and categorisation.

This study aims to thoroughly understand and explore the environment of Indonesian regulations and laws related to the Islamic banking system and MSMEs and unveil the restrictive law and regulatory flaws that potentially hinder the Islamic banking institutions and the MSME industry in achieving financial inclusion. Subsequently, this study also analyses the perception of Indonesian Islamic banks and MSME entrepreneurs regarding the regulatory requirements and how they behave to address these regulatory challenges to achieve Islamic financial inclusion. After the issues and problem has been identified, this paper will attempt to propose several suggestions to boost the achievement of MSME Islamic financial inclusion from the regulatory aspect and amplify the chance for MSME units to gain access to Islamic financial services. Therefore, to achieve these detailed objectives pertaining to the laws and regulations associated with Islamic banks and MSMEs and their behaviours towards the regulatory requirements, the implementation of qualitative methods through the adoption of case study is preferred over the quantitative approaches. By incorporating a case study research strategy, in-depth information could be acquired from the participants in their current condition, and a greater level of understanding regarding the behaviour and attitude could be achieved using this type of study, which cannot be captured using the quantitative means (Dudovskiy, 2018). Besides, the case study approach may offer a good opportunity for innovation and could change the current theoretical assumptions (Queirós *et al.*, 2017).

This study uses the anonymised code to safeguard the privacy of respondents that contribute to the substantial data and extensive information gathered for this research, and simplifies the mention of the respondents, both from Islamic banks and MSME participants. The lists of the respondents' data and codes are disclosed in Tables 1 and 2 below:

It is critical to highlight that since this paper incorporates a case study approach, hence, the required number of samples is not relevant for this kind of study. Yin (2014) argued that the purpose of the case study research is not a statistical generalisation, and he asserts that since the researcher's cases are not "sampling units" and should not be chosen for this reason. Rather, individual case studies are to be selected as a laboratory researcher selects the topic of a new experiment; and multiple cases, in this sense, should be treated like multiple experiments. Therefore, under these conditions, the mode of generalisation is "analytical" rather than statistical (Yin, 2014). Subsequently, Boddy (2016) elaborated that a single case study involving a single participant could be of importance and generate substantial insight. This coherently means that the smallest acceptable sample size in this type of qualitative study is a sample of one. Hence, the importance of the study escalates once there are more cases to be investigated, such as in the case of "multi-case" study research.

The main reason for this study to purposefully select six Islamic banks and 22 MSME units is because the scope and nature of this study are to profoundly understand and explore the perceptions and behaviours of Islamic banking institutions and the MSME industry in regard to the regulatory requirements, and how these regulatory environments affect their day-to-day operation, which eventually influences both segments' roles in realising MSME financial inclusion. Hence, in this context, the sample should be representative of the two sides of financial inclusion, which consist of Islamic banks (supply-side) and MSMEs (demand-side). The Islamic banks were represented by three commercial banks and three rural banks that dominate the Islamic banking industry in Indonesia, while the MSMEs were represented by 11 MSME units both from the urban and rural locations from diversified sectors. These representatives, both from the Islamic banking segment and the MSME sector, should provide substantial insight and in-depth discussion of the case being investigated regarding the regulatory environment and conditions in promoting Islamic financial inclusion for the MSMEs. Moreover, another reason for this kind of participant selection is to expose the new and unique phenomena, attitudes and approaches involving different types of Indonesian Islamic banks and MSME industry in the urban and rural orientation, particularly in the aspect of regulatory constraints and how they address these particular challenges.

4. Findings and discussion

4.1 Regulatory challenges hindering the micro-, small- and medium-sized enterprises financial inclusion from the Islamic bank side

4.1.1 Regulatory requirement compliance. As disclosed by the earlier literature, the Government of Indonesia requires the banking institutions to set aside a minimum of 20% credit ratio for the MSME industry and imposes disincentives if the banks are unable to achieve this mandated ratio (Bank Indonesia, 2012a). In this concern, according to the interview data, all surveyed Islamic banks agree that they perceive and regard this

Table 1. List of respondents' code and data from the Islamic banking segment

Islamic bank (IB) participants	Segment	Code	Respondent's position	Experience (Years)	Interview duration (Minutes)	Word count of transcribed interview
1	Commercial bank	*IB01*	Head of SME banking division	18	100	17,147
2	Commercial bank	*IB02*	Manager of micro banking division	9	191	24,364
3	Commercial bank	*IB03*	Head of retail banking business	6		
	(Islamic window)		Head of Sharia business operation risk	14	117	17,022
			Head of Sharia governance	15		
4	Rural bank	*IB04*	Executive director	18	57	8,882
5	Rural bank	*IB05*	Executive director	7	43	5,326
			Operations director	15		
6	Rural bank	*IB06*	Executive director	17	130	17,574
Total participants (Islamic banks)			*6*		*Total duration* *638*	*Total word count* *90,315*

Source: Authors' own

MSME participants	Location	Sector	Code	Interview duration (Minutes)	Word count of transcribed interview
1	Urban	Service	*S01*	124	17,566
2	Urban	Service	*S02*	105	14,494
3	Rural	Animal husbandry	*S03*	91	16,585
4	Urban	Trading	*S04*	65	10,682
5	Urban	Trading	*S05*	111	17,742
6	Urban	Food industry	*S06*	47	9,519
7	Urban	Food industry	*S07*	26	5,296
8	Urban	Service	*S08*	55	10,668
9	Urban	Service	*S09*	55	9,529
10	Urban	Street vendor	*S10*	30	7,863
11	Urban	Trading	*S11*	21	4,570
12	Urban	Trading	*S12*	33	7,651
13	Rural	Food industry	*S13*	53	7,348
14	Rural	Trading	*S14*	31	5,218
15	Rural	Agriculture	*S15*	28	5,615
16	Rural	Street vendor	*S16*	39	6,701
17	Rural	Construction	*S17*	49	8,665
18	Rural	Fishery	*S18*	52	9,441
19	Rural	Mining	*S19*	34	6,149
20	Rural	Animal husbandry	*S20*	50	8,451
21	Rural	Manufacturing	*S21*	25	4,959
22	Rural	Trading	*S22*	28	5,051
Total participants (MSMEs)			*22*	*Total duration 1,152*	*Total word count 199,763*

Source: Authors' own

Table 2.
List of respondents' code and data from the MSME segment

regulation as positive since this mandatory regulation was aimed to strengthen the MSME sector and promote their growth in the long run (Figure 3). The following statements reveal the studied Islamic banks' perception regarding the mandatory 20% credit allocation for the MSME sector:

> *IB01*: Well, for this regulation, we welcomed it positively, meaning that the government cares about the MSME development. Hence, we perceive it as a good initiative, and we have prepared its apparatuses.

Source: Authors' own (ATLAS.ti 8.0)

Figure 3.
Word cloud trend of observed Islamic banks' perception on minimum 20% credit ratio for MSME segment

IB02: Well, for our bank, we are indeed continuously trying to increase our financing portfolio allocation for the MSME. And our MSME portfolio is reasonably good so far, and we attempt to adhere to this government regulation persistently.

IB03: Since our regulator mandated a certain percentage for the MSME segment. Therefore, we need to achieve those percentages. Maybe our initiatives to expand its market share are more like to achieve that mandated percentage. For IB03 bank particularly, I think the bank does its best to fulfil that regulation, and indeed, we have considerable effort to increase MSME market share.

IB04: Well, I think this minimum ratio should be more, because the MSME sector was the core economic driver for our country and the one and the only sector that was intact during the economic crisis. During this COVID-19 pandemic, if we do not subsidise this core sector, this may lead to the collapse of the MSMEs sector, and it is hazardous for Indonesia's economy. Therefore, I extremely agree and support this 20% minimum ratio, but, in fact, I demand more.

IB05: We have no issue regarding this requirement since we allocate our financing portfolio more than 20% for the MSME sector.

IB06: Yes, we do not have any issue with this regulation. In fact, based on our experience from this pandemic, although the regulation standard was 20% at the minimum and we reached that number quite far; therefore, due to this condition, we think that we should diversify our financing portfolio to another sector and hence, the financing allocation for MSME could decrease from 70% to 60%.

However, apart from the previous statements, based on the recent IB01 annual report (2019), in the past five years, from 2015 to 2019, their MSME credit portfolio showed a decreasing trend from 27.86% to 16.85% out of the total credit portfolio (IB01, 2019). Since the IB01 bank merely achieves a percentage lower than the 20% mandatory regulation; hence, it is obligatory for the bank to give and conduct the training and workshop programmes for MSME entrepreneurs that are currently not served by the bank. Nevertheless, the IB01 bank regard this sanction as a positive approach made by the Indonesian Government to amplify the development of the MSME sector. Therefore, despite the disincentive imposition, the IB01 bank is fully supporting this MSME financing regulation. Subsequently, based on the IB03 annual report of 2020, the IB03 bank also merely achieved a 4.84% and 4.06% MSME financing portfolio in 2019 and 2020, respectively; therefore, the bank was also subjected to the penalty and was mandated to provide the training and seminars for MSME entrepreneurs that currently not served by the bank as the sanction for not achieving minimum 20% credit ratio for MSME segment (IB03, 2020).

Moreover, regarding the Bank Indonesia regulation that merely gives the relaxation to the conventional bank (Bank Indonesia, 2015), the Islamic commercial bank respondents perceive this regulation as burdensome and challenging; hence, they expect that the government should also consider the Islamic bank for this relaxation and relief from minimum reserve requirement or through other mechanisms, such as stimulus, incentives and benefits to boost the development of Islamic financial institution in Indonesia. As expressed by studied Islamic bank respondents from the commercial segment, this relaxation and relief could encourage and motivate the Islamic bank to give more financing and provide better services for the MSMEs sector. One of the respondents from the IB03 bank argued that this regulatory decision was issued since the regulator perhaps has their own consideration and policy regarding the applicability of this particular relaxation for the conventional banking segment and not for the Islamic banking industry. As the respondent further reveals, there is a subliminal or hidden message that the Islamic bank should have a solid and robust capital basis before they are eligible for any relaxations and incentives since the regulator might perceive that the Islamic banking industry has considerably smaller capital compared to the conventional banking sector and hence, they were not eligible for such incentives.

Interestingly, from the Islamic rural bank segment, the respondents pointed out that their banking segment was not heavily impacted by this regulation which merely gives relaxation to the conventional banking industry and has no issues in this regard. This occurs since the rural banking segment has no involvement in payment transferring and has narrower services and facilities compared to the commercial banking segment. Nevertheless, one of the respondents from IB06 bank mentioned that although the rural bank has no direct involvement in the payment transfer and has no issues in this matter, this does not rule out the possibility that the government and regulator could issue incentives and supportive regulation for the Islamic banking industry to motivate them more to serve and reach out for the MSME community.

Additionally, concerning the dual regulations issued by BI and OJK, all of the observed Islamic banks have a consensus that these dual regulations support each other in strengthening the banks' prudence and accountability. However, as mentioned by one of the respondents, since these dual regulations were issued by two different regulators, there is some possibility of contradiction in regulatory requirements on the micro-levels and legislation overlapping, as well as poor co-ordination, particularly for the regulations that relate to the payment system.

4.1.2 Product and service provision. Concerning the regulatory challenges in products and services provision, there are several reports and disclosures made by some of the Islamic banking participants pertaining to challenges and constraints in providing Islamic banking financial services due to regulatory barriers. In this context, the IB01 respondent mentioned several factors inhibiting the implementation of profit and loss sharing (PLS) products, such as *Mudharabah* and *Musharakah*; among these factors are the restrictive regulations that govern this kind of financing and the limited availability of technology and system that could simplify the profit-sharing calculation and synchronise this respective information across the entire banking system. In fact, the IB01 respondent reveals that since *Murabahah* is more straightforward in terms of the accounting application, fixed pricing model, and minimal requirement for day-to-day monitoring; therefore, this type of contract is still preferable and used by many Islamic banks because of its low-cost nature.

Subsequently, the IB03 respondents also reveal why most banks rarely use PLS schemes in their financing disbursement; one of the crucial reasons in their perspective is the limitation of the banking system in applying and implementing the *Musharakah* and *Mudharabah* scheme. As the respondents further argue, not all banks have a holistic system and infrastructure for executing the profit-sharing mechanism since this kind of contract calculates projected earnings and how much the realised profit was shared between the bank and the customers.

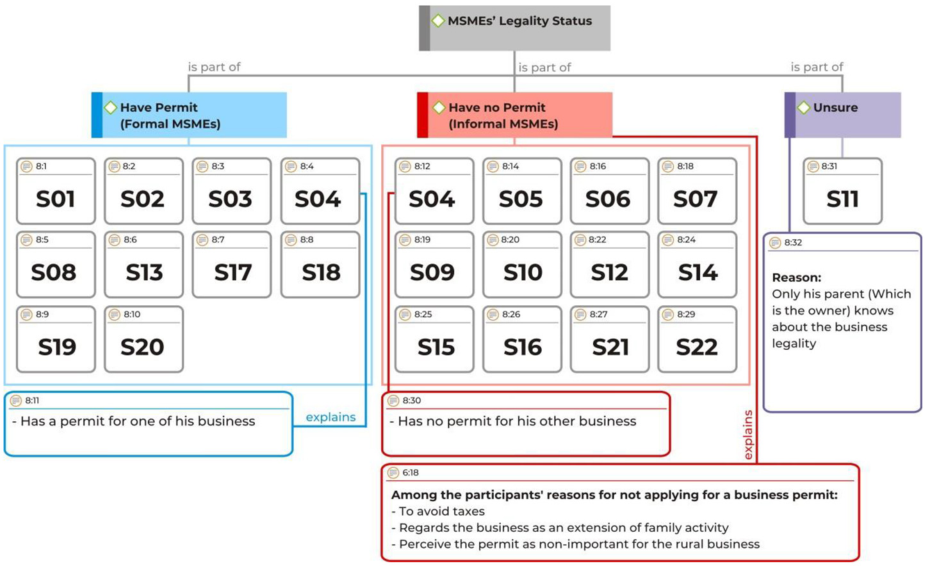
Furthermore, the IB06 also reported several issues and challenges in conducting the PLS financing scheme. In this matter, the respondent pointed out that contracts like *Mudharabah* and *Musharakah* need more rigorous analysis and more detailed assessment compared to the *Murabahah* contract. Moreover, besides its complex mechanism, the implementations of PLS products and services are more challenging from the regulatory aspect due to the provision of loan losses and complex regulatory procedures compared to the *Murabahah* contract. In fact, the highest risk of using the PLS scheme comes from the legal dispute between the bank and the customer during the customer default. This problem occurs because most customers have a minimum understanding of how the PLS mechanism works.

Their poor perception and lack of understanding might create loopholes in the legal dispute that might be used against the banks to run away from their financial obligation.

4.2 Regulatory issues hampering the micro-, small- and medium-sized enterprises financial inclusion from the micro-, small- and medium-sized enterprises industry side

4.2.1 Legality status. One of the critical issues and challenges faced by MSMEs is their legality. This condition would consequently affect their opportunity to access external finance and participate in the government assistance programme, thus, decreasing their chance to embrace financial inclusion and curb their contribution to the country's economic growth. As specified by the interview data, ten MSME participants (S01, S02, S03, S04, S08, S13, S17, S18, S19 and S20) reported having some kind of business legality/permit to operate their business. In comparison, the eleven MSME participants (S05, S06, S07, S09, S10, S12, S14, S15, S16, S21 and S22) revealed that they do not have any business legality/permit in operating their business. However, one participant (S11) elaborated that he was unsure about his business permit since he only acts as a business manager and only his parent (the owner) knows about its legality. Interestingly, another respondent (S04) reveals that he has two types of business and merely applies for a permit for one business and neglects another (Figure 4).

Among the respondents' reasons for not applying for a permit for their business are to avoid taxes (S04), regard their business as an extension of family activity, and thus, no requirement for legality (S07, S09, S14, S15, S16 and S22), and perceive the legality as non-importance since their business is operated in the rural area, and it is extremely rare for the micro and small-scale business to have a proper business permit (S14, S15, S16 and S22). However, several MSME respondents are interested in applying for a business permit in the future. Among the reasons for their interest in applying for a business



Source: Authors' own (ATLAS.ti 8.0)

Figure 4.
MSME participants' legality status

permit are security reasons (S05), legal force protection (S06), increasing the business revenue (S10), encouraging proper business management (S12) and expanding the business into the upper segment (S21). The S21 respondent further revealed that he attempted to apply for a business permit before; however, due to the difficult and expensive requirements, he postponed his permit application until he was able to fulfil those particular requirements.

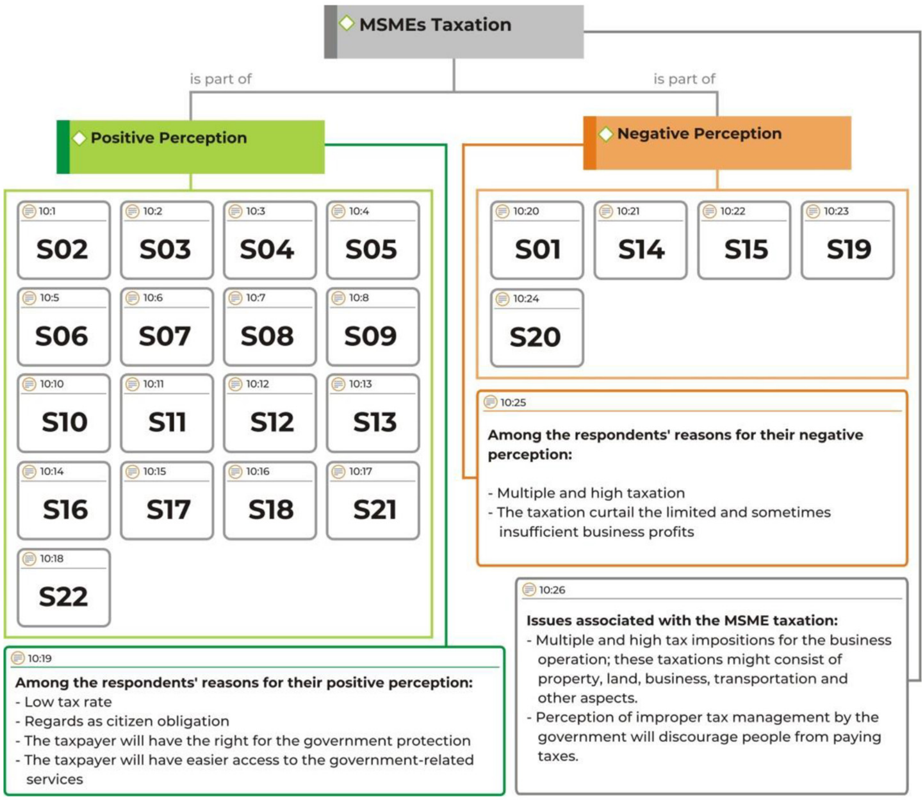
Furthermore, concerning the respondents' experience in obtaining the financing facility, most of the formal MSMEs (S01, S02, S03, S04, S08, S19 and S20) using some sort of financing facility disclosed that it is obligatory to provide a business permit or business certificate to access financing facility from the bank. Nonetheless, only one formal MSME (S18) reported using the personal loan for his business operation; therefore, the bank does not require any business certificate to approve his loan facility. However, although the bank does not ask for a business permit, the respondent further reveals that the bank staff still visits his business to inspect the business location and condition. Moreover, two informal MSMEs (S06 and S16) revealed that they do not need any business legality to obtain financing services. As for the S06 respondent, she mentioned that she obtained this facility from a cooperative institution that requires no business permit. An interesting case happened with the S16 respondent; he explained that he had access to the Kredit Usaha Rakyat (KUR)/People Business Credit) facility, a subsidised government assistance programme, since the respondent was relatively close to the head of the bank branch and approved his KUR application with no permit requirement; nonetheless, as the respondent further disclosed, before the KUR application was approved, the bank staff still visits his business to assess his business eligibility for the KUR programme.

In addition to the aforementioned issues, some MSME participants further reveal that although the application for a business permit is easy; however, the application for permit extension is complicated (S01, S02). As both respondents mentioned, this issue arguably occurs since the authority change will consequently alter the business policy, particularly the policy that governs the business permit and its procedures. Subsequently, several MSME respondents also reveal that the place eviction becomes their major concern for their business sustainability, and this problem will affect their customer numbers and decrease their revenues since their initial business place is known well by their customers (S05 and S09). Another respondent disclosed that municipal police inspection and control become the primary challenges for the survivability of the street vendor business in the urban area (S10).

4.2.2 Taxation. Since formal MSMEs are subject to MSME taxation, which is around 0.5% per annum for a business with revenues less than IDR 4.8 billion annually (ILO, 2019), it is essential to explore the MSMEs' perception regarding MSME taxation to understand their inclination to embrace financial inclusion. This is critical since a positive perception towards taxation will influence the informal MSME to register their business and increase their chance to access external financing due to proper business formality, and for the formal MSME to develop their business better and demand more access to financing services due to the supportive taxation environment.

In this regard, based on the interview data, most MSME respondents perceive this MSME taxation as positive. Among the respondents' reasons for their positive view is that they perceive this 0.5% MSME tax rate as the low one (S02, S04, S06, S07, S08, S09, S10, S11, S12, S16, S17, S21 and S22), some of them regard it as a citizen obligation (S03, S05 and S09), others perceive that the taxpayer will have the rights for the government and legal protection (S13), and have easier access to the government-related services (S18). However, S09 and S10 respondents mentioned that despite their positive perception of MSME's low taxation, their perception could become negative if the government inappropriately manages the tax funds and neglects MSME growth. On the other hand, some MSME respondents consider this taxation negative. Among the reasons for their negative perception are that their business is subjected to multiple and high taxes (S01, S15 and S19), and this taxation curtails their limited and sometimes insufficient profits (S14 and S20) (Figure 5).

Moreover, several MSME respondents disclosed several issues and challenges associated with business taxation. The S01 respondent elaborated on the issues of multiple and high taxations for his medium-scale printing business. He mentioned that besides property and enterprise taxes, his business was also subjected to high and burdensome import taxes. Subsequently, the S15 respondent also revealed the issue of multiple land and property taxes, even for the small farming business. This taxation burdens her since she has big-sized and multiple lands for farming, in which the taxation is based on the land size, and she has no certainty in getting a profit from farming due to external factors, such as weather and pest. Moreover, the S19 respondent reported a similar condition that his medium-sized mining business is also subjected to multiple taxes, such as property, machinery and transportation taxes that sometimes encumber the business's operational cost. Besides, the



Source: Authors' own (ATLAS.ti 8.0)

Figure 5.
MSMEs' perception towards taxation and its associated issues

S09 respondent hinted at the improper management of taxes by the tax officials, and this issue discourages people from paying taxes due to the perception of corrupt management.

4.3 Analysis and discussion

4.3.1 Analysis and discussion from the Islamic bank side. From the earlier findings and revelations related to the regulatory compliance of the 20% minimum credit ratio, all of the Islamic banking participants agree that they support this government initiative since this mandatory ratio will consequently improve the chance of the MSME sector in obtaining access to finance and promote the growth of this promising industry in the long run. Nevertheless, despite their support and positive view regarding this ratio, two Islamic commercial banks have not been able to achieve this required ratio based on their recent annual report (IB01, 2019; IB03, 2020), signifying that the MSME segment has not been the banks' primary focus in their financing disbursement. Subsequently, this study's findings also contradict what has been stated earlier by the literature (Sudarwan, 2018; Soemanagara, 2019), disclosing that the smaller banks are struggling to attain this obligatory ratio; while, in fact, the smaller banks that consist of Islamic rural bank group were committed and able to comply with this regulatory standard. Perhaps the literature statement was partly true for several banks that have not been focusing on the MSME segment earlier; hence, they find it challenging to comply with this minimum 20% credit ratio when the regulation is put into effect.

Furthermore, from the aspect of regulatory issues that merely gives minimum reserve relaxation to the conventional bank, the Islamic commercial bank participants perceive this regulation as burdensome and challenging for the development of the Islamic banking industry, particularly in serving the MSME sector. In response to this regulation discrepancy, most respondents agree that they expect the regulator and the government to consider these kinds of relaxation for the Islamic banking industry or through other mechanisms, such as the provision of stimulus, incentives and benefits to encourage and motivate the Islamic banking segment to disburse more financing and provide better services to the MSME industry. This empirical finding regarding the regulatory imbalance from the Islamic banking side supports what has been implied by the theoretical literature stating that the weak institution and poor competition (in this case, between Islamic and conventional banking industry) will hinder the finance-induced economic benefits (Rajan and Zingales, 2003; Demetrieades and Hook Law, 2006; Marcelin *et al.*, 2022). Subsequently, the earlier theoretical discussion suggests that the positive relationship between financial inclusion and a politically stable environment will boost overall economic well-being (Allen *et al.*, 2016; Ahamed and Mallick, 2019; Marcelin *et al.*, 2022). Furthermore, as revealed by the studies focused on institutional theory, the flaws and restrictive regulatory framework will negatively affect the involved institutions' behaviours and hinder financial inclusion (Figart, 2013; Seman, 2016; Saifurrahman and Kassim, 2023).

Subsequently, the dual regulation issued by BI and OJK does not present a challenge for most Islamic banking participants. However, one of the respondents hinted at the possibility of regulatory contradiction, legislation overlapping and poor coordination on the micro-regulatory level, particularly that related to the payment system. This revelation partly verifies the IFC (2016) report pertaining to the regulatory inconsistencies that were issued by the two primary regulators in Indonesia.

Moreover, concerning the product and service provision, some Islamic bank participants pointed out the regulatory challenges in implementing PLS contracts, such as accounting application, provision of loan losses and weak bank position during the customer default event. This issue explains why most Islamic bank participants minimally use the PLS scheme, such as *Mudharabah* and *Musharakah*. Besides the regulatory challenges, the respondents also reveal that the complex procedures and high monitoring costs became other critical reasons why Islamic banks rarely use PLS products and opt to use debt-based products, such as *Murabahah*, due to its low-risk and low-cost nature compared to the equity-based products. This finding justifies several studies disclosing that Islamic banks in Indonesia were reluctant to use equity-based financing and preferred to use debt-based financing due to its low-cost and low-risk advantages (Huda, 2012; Suharto and Fasa, 2017; Yustiardhi *et al.*, 2020). Interestingly, as discussed earlier in the literature, since the issues of PLS contract implementation are associated with the risk of information asymmetry between Islamic banks and MSME clients, this issue could be reduced by incorporating the role of technology. Risk management theory related to financial intermediation considers how technological deepening may alleviate the issue of asymmetric information and transaction cost in financing relationships (Allen and Santomero, 1997). Besides, mature economics typically instilled technology and implemented deregulatory policies to solve structural constraints, and thus, facilitating economic growth by increasing productivity, reducing transaction costs, promoting innovation and fostering overall growth (Chatterjee, 2020; Wellalage *et al.*, 2021).

From economic intuition standpoint, the aforementioned analysis and discussion from the side of Islamic banks show that the regulatory framework plays a significant role in enforcing the financial institution to reach the specific customer segment, particularly the vulnerable ones, such as MSMEs. The 20% mandatory credit ratio is proven to coerce the Islamic banks to serve the MSME sector by increasing their financing quota and consequently improve the chance of this vulnerable sector to obtain financing facility; hence, the enforcement of this regulation need to be maintained and improved to cover all MSME sector and not only for a specific group of MSMEs. Furthermore, the earlier discourse suggests that the restrictive laws and regulatory flaws could hinder the banking industry from performing their operation in the optimal ways and discouraging them from serving the needs of low-segment clients due to the asymmetric information and high-risk concerns, such as MSMEs; therefore, a robust regulatory framework and incorporation of technology is needed to realise financial inclusion (Figart, 2013; Chatterjee, 2020; Wellalage *et al.*, 2021), and to encourage the financial industry to reach out all segment of society, and contribute to the overall growth (Hunjra *et al.*, 2022).

4.3.2 Analysis and discussion from the micro-, small- and medium-sized enterprises side. Concerning the MSME legality status, the finding identifies that the majority of surveyed MSMEs are still informal; hence, this informality will affect their chance to apply for any financing services and benefit from the government assistance programme. In fact, one of the MSME respondents specified that this legality is exceptionally critical for participating in the government programme and for applying to any banking services since this legality indicates the business owner's commitment to operating their business and serves as proof of legal business existence in the respective region (S08). Nevertheless, concerning this formality's importance, some MSME respondents are interested in applying for a business permit in the future to strengthen and improve their business condition, particularly in the aspect of legal force, security, revenues and business management. Moreover, several MSME participants report that although the application for the business permit is relatively easy for their business, nonetheless, complicated procedures occur when extending the business permits due to local government and regulatory inconsistencies. The earlier theoretical studies imply that the regulatory barriers and constraints could impose an obstacle for the business, particularly the MSME industry. The complex regulatory requirements and complicated administrative and bureaucratic procedures create a strain, and result in additional costs for the enterprise to enter the market. Such aforementioned costs are considerably higher for the micro, and small business segment since regulation usually entails a fixed cost (Nassr *et al.*, 2016; Saifurrahman and Kassim, 2021). Hence, these issues might include the complicated business permit and expensive procedure for MSME to enter the market and discourage most of the entrepreneurs from registering their businesses, which, in turn, dwindles their chances of accessing financing facilities either from the banks or other FSPs.

Subsequently, from the aspect of taxation issues, the majority of the MSME participants have a positive perception regarding the low taxation rate for the formal MSME with a proper permit, which is around 0.5% per annum. Nevertheless, despite the MSME's low taxation as it might seem, several MSME respondents mentioned the issue of high and multi-taxation for their business. Some of them complained that besides the enterprise tax, their business is also subject to multiple taxes, such as building, land, import, machinery and transportation taxes. As revealed by the previous surveys, besides the lengthy and costly procedure for business registration, the issues of taxes also discourage the MSME from official registration. According to the reports, a regular medium-sized company will pay around 31.4% of its profit in taxes and spend 253.5 h a year approximately for filing and paying taxes (World Bank, 2014b; IFC, 2016). In this concern, as mentioned earlier in the theoretical literature, the robustness of the legal and regulatory framework and transparent tax mechanism is essential to boost the MSMEs' development (Atkinson, 2017; Saifurrahman and Kassim, 2021).

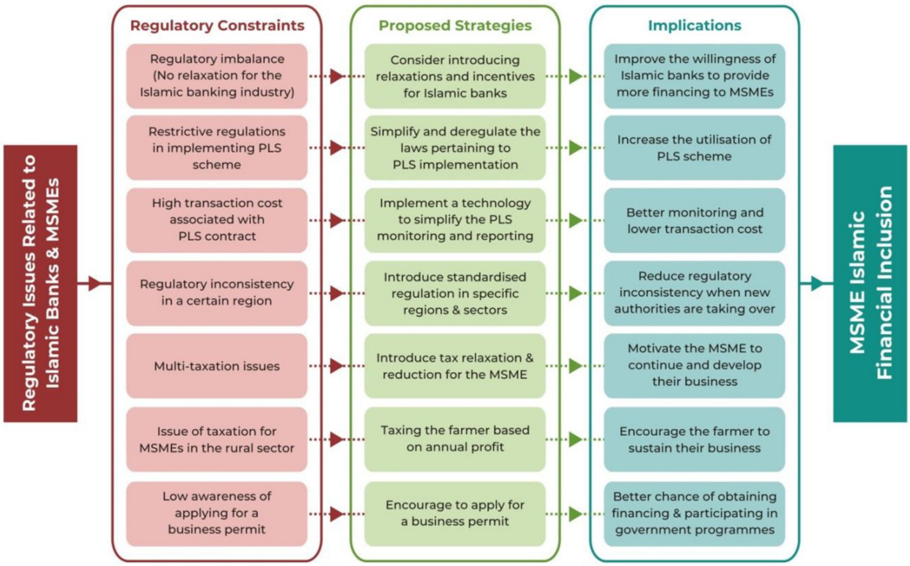
From the economic intuition perspective, the earlier analysis and discussion related to the MSMEs reveal that the complex regulatory requirements and bureaucratic procedures could inflict a burden and discourage the MSMEs from getting a proper business permit and entering the formal market. Moreover, the opaqueness of the taxation system may demotivate the MSME entrepreneurs in extending their business permits due to high and multiple taxes imposed for a certain business/sector. Thus, it is imperative to introduce more simplified registration procedures and more transparent taxation frameworks to encourage more MSMEs to apply for a permit and sustain their business, which eventually improves their opportunity to obtain financing access and government support programmes, hence, participating in the overall economic expansion.

4.4 Implications and recommendations

From the abovementioned findings and discussion on the regulatory aspect for MSME Islamic financial inclusion, there are two important practical implications that could be drawn from this study. Firstly, from the side of the Islamic banking industry, the finding implies that the regulatory imbalances and restrictions could hinder the efforts of Islamic banks in providing access to finance for the MSME industry, hence, encumbering the realisation of the financial inclusion agenda from the Islamic banking industry. These issues could be observed in how the regulatory imbalances pertaining to the minimum reserve requirements relaxation could demotivate the Islamic commercial banks in disbursing more financing to the MSME segment. Furthermore, the restrictive regulation on PLS applications presents challenges for Islamic banks. Therefore, this problem explains why most Islamic banks rarely use PLS schemes in their financing contract, particularly for the MSME sector, due to higher perceived risk. Secondly, from the side of the MSME segment, the finding suggests that the flaws in MSME registration and taxation might discourage the formal MSME from extending their business license and prevent the informal MSME units from registering their business. This issue would consequently lower their chance of accessing external financing from the formal financial institution and participating in government assistance programmes due to the absence of proper enterprise legality.

Therefore, by referring to the earlier constraints and problems, several recommendations and suggestions could be adapted to address these regulatory restrictions and flaws to boost the achievement of MSME Islamic financial inclusion, among others (Figure 6):

- The regulators should consider the relaxation and incentives for the Islamic banking industry, particularly for the regulations associated with MSME financing. This is to motivate and improve the willingness of Islamic banks to provide more financing to the potential MSME sector. The prior theoretical literature suggests that the supportive institutional environment in which the bank operate may motivate and augment their way of doing business (Williamson, 1996; Marcelin and Mathur, 2014; Mathur and Marcelin, 2015).
- The regulators should review and consider the simplification of regulation that governs the PLS-based project, particularly on contract requirements and implementation procedures. This is to encourage the Islamic financial industry to use more PLS contracts in their financing scheme, which may increase the chance for MSMEs to gain access to finance. The previous theoretical studies also imply that deregulatory policies could address structural constraints (Chatterjee, 2020; Wellalage *et al.*, 2021), which may relieve the Islamic banks' hindrance to use PLS scheme and amplify the banks' innovation to serve the MSMEs using the PLS mechanism.
- To reduce high transaction costs associated with the PLS scheme implementation, the Islamic bank should collaborate with academia from the Islamic finance institute and informational technology company to develop specially designed e-applications



Source: Authors' own

Figure 6. Proposed strategies to address the regulatory constraints

that could simplify and synchronise the profit-sharing project monitoring and reporting and make it user-friendly to the end-users, especially for MSME entrepreneurs. As the earlier theoretical literature indicates, the role of ICT could potentially promote financial inclusion by decreasing asymmetric information and reducing transaction costs (Allen and Santomero, 1997; Scholtens and Van Wensveen, 2003).

- The local government should establish and introduce standardised regulations that regulate the MSME industry in their respective region and sector. This is to reduce the regulatory inconsistencies and alterations that might happen when the new authorities are taking over. This aspect is reinforced by the institutional theory suggesting that precise coercive pressure will force the institutions' procedures to achieve their intended objectives, which in this case, the public sector serving the MSMEs and MSME segment in fostering Islamic financial inclusion (Saifurrahman and Kassim, 2023).
- Concerning the multi-taxation issue, the government should consider introducing a tax relaxation and reduction for the MSME segment to lessen the entrepreneur's burden in fulfilling their tax obligation and motivate them to continue and develop their business. This point was supported by the theoretical argument stating that the transparent and encouraging tax environment is critical to promote the MSMEs' development (Atkinson, 2017; Saifurrahman and Kassim, 2021).
- The government should also consider taxing the MSMEs operating in the agriculture sector based on their annual profit rather than taxing their land used for farming as a method of business incentive for the farmers. This issue occurs since most farmers have big-sized land for farming, and if the tax follows their land size, this will undoubtedly impose higher taxation on the farmer with the bigger land. Consequently, the farmer in the rural area will tend to sell their land if they have a disadvantaged tax position rather than continuing their farming profession.
- Despite MSME registration and taxation flaws, MSME entrepreneurs should consider applying for a business permit sooner since this permit acts as the primary gate to obtain financing services and participate in government support programmes. This is because the benefits of having a formal business license outweigh the risk of regulatory burdens associated with formal enterprises.

In addition to the abovementioned practical implications, from the theoretical implication standpoint, the earlier findings validate and strengthen the theoretical concepts and arguments – both from the institutional theory and risk management theory – suggesting that supportive institutional environments, as well as the roles of ICT and technology, will have positive and constructive influences over the supply and demand-side of financial inclusion and promote sustainable development. Conversely, any negative flaws and restrictions from previous aspects would lead to adverse consequences both to the supply and demand side of financial inclusion and hinder economic growth.

5. Conclusion

This study extensively explored the law and regulatory environment related to the Islamic banking system and MSMEs in Indonesia and unveiled the restrictive laws and regulatory flaws that potentially impede the Islamic banking institution and MSME industry in achieving financial inclusion and promoting sustainable growth. The findings disclosed two essential issues and answered two earlier research questions: the regulatory imbalances and restrictions could demotivate and hinder the efforts of Islamic banks in providing financial services for the MSME segment, therefore, constraining the achievement of the financial inclusion agenda from the Islamic banking industry. The flaws in MSME registration and taxation could discourage the formal MSME from extending their business license and prevent the informal one from registering their business. This problem would consequently decrease their chance of accessing external financing from formal FSPs and participating in supportive government programmes due to the absence of proper business legality.

From the policy implication perspective, the introduction of relaxation and incentives, as well as deregulatory policies pertaining to the PLS scheme, is imperative to motivate the Islamic banking industry to serve the MSME sector better. Subsequently, a more transparent tax framework and a shorter bureaucratic procedure are crucial to encourage the informal MSMEs to register their businesses and stimulate the formal ones to continue their operation. These mechanisms will potentially promote more inclusion of MSMEs into Islamic financial services and participate in sustainable growth for the overall Indonesian economy.

However, since this study only observed six Islamic banks and 22 MSME units in urban and rural orientation in Indonesia using a case study approach; therefore, the empirical findings and case discussion were merely limited among those particular Islamic banks and MSME participants. Due to this limitation and drawback, the future study could be extended by observing and investigating more Islamic banks and MSME entrepreneurs or alternatively by incorporating the multi-cross-institution research that compares the banks and non-bank institutions to unveil various issues, behaviours and perceptions involving different participants and FSPs in relation to the regulatory aspect that promote financial inclusion for the MSME sector.

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