

Islamic Financial Institutions and Financial Inclusion: A Comparative Study of Malaysia and Indonesia

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Abstract: This paper will compare and contrast heights of financial inclusion strategies adopted by Islamic Financial Institutions (IFIs) in Malaysia and Indonesia and specifically discuss Islamic social finance instruments, digital finance and community-based models. By using thematic analysis applied to a variety of policy documents, as well as institutional and implementation strategies, a qualitative comparative approach that is based on secondary data, the study analyzes policy documents and institutional and implementation strategies. The findings indicate that Malaysia follows a policy-based, centralized, and robust regulatory coordination, digital enablement, and integration of Value-Based Intermediation (VBI) and Islamic social finance tools. By contrast, Indonesia uses a decentralized and community-based model, which is powered by Islamic microfinance institutions, including Baitul Maal wat Tamwil (BMTs) with strong grassroots penetration but with issues in terms of standardization of governance and digital readiness. This research study is of value because it presents an integrative analytical model that connects the governance systems, digital integration, and Islamic social finance in determining the financial inclusion outcomes. It sheds light on significant trade-offs between efficiency and inclusiveness, centralization and flexibility, and provides policy relevant insights towards improving inclusive Islamic finance ecosystems.

Keywords: Islamic finance, Financial inclusion, Malaysia, Indonesia, BMT, Zakat, waqf, Islamic social finance, Digital finance, Value-Based Intermediation (VBI).

1. INTRODUCTION

Financial inclusion has become one of the main concerns in economic development over the last few decades, especially in the developing nations that aim at alleviating poverty and achieving inclusive growth. The ability to access and utilize affordable, appropriate and sustainable financial services which include payments, savings, credit and insurance is often defined as financial inclusion (World Bank, 2022). It is highly important in promoting the United Nations Sustainable Development Goals (SDGs), and in particular, the goals that strive to curb poverty, inequalities, and gender disparities (Demirgüç-Kunt *et al.*, 2018). Nevertheless, Shariah compliance and not mere access has made financial inclusion an issue of concern in Muslim majority countries. A large percentage of the population has not been served satisfactorily since religion has raised concerns about the conventional financial systems. In this regard, Islamic Financial Institutions (IFIs) are very important to offer inclusive financial services according to the Shariah principles and thus providing an alternative way of achieving socio-economic development (Iqbal and Mirakhor, 2011; Abdullah, 2018).

Malaysia and Indonesia are two of the most obvious and structurally different Islamic finance ecosystems and are the most common Muslim-majority countries.

Malaysia has also embraced a policy-driven, centralized approach that is characterized by robust regulatory controls under Bank Negara Malaysia, incorporation of the Islamic social finance tools such as zakat and waqf, and the development of digital financial platforms (Bank Negara Malaysia, 2023). This formalized model has helped Malaysia to attain high standards of coordination, scalability and innovation in the Islamic financial inclusion. Conversely, Indonesia has worked out a decentralized, community-based model where institutions, particularly the Baitul Maal wat Tamwil (BMTs), have a substantial influence in extending financial services to the underserved groups. These institutions fulfill both social (maal) and commercial (tamwil) roles and are deeply entrenched in the local communities, especially in rural areas (Ascarya & Suharto, 2022; Ginanjar and Kassim, 2021). In as much as this model improves accessibility and social trust, it has issues with regard to fragmentation of governance, capacity of institutions, and sporadic use of digital.

These differing strategies undertaken by Malaysia and Indonesia underscore several key points that reflect differences in governance systems, institutional frameworks and implementation strategies. In as much as the centralized model in Malaysia enhances efficiency and scalability, the decentralized model in Indonesia focuses on scorecards that are more inclined at inclusiveness and community involvement. These distinctions present a useful ground on which to make comparative analysis. Though there are previous

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investigations that explored the question of the Islamic financial inclusion with forms being used in the individual country context, there are very few studies that systematically integrate the frameworks of the governance, digital financial ecosystems and Islamic social finance instruments within a unitary analytical framework. Moreover, a bibliometric analysis by Shamimi Mohd Zulkarnaini and Rusni Hasan suggests that the current body of literature is fractured, with little focus on the comparative institutional analysis and interaction between the governance, fintech, and social finance (Zulkarnaini and Hasan, 2025). This paper fills these gaps by formulating a comparative analytical framework connecting governance models (centralized vs decentralized), digital integration, and Islamic social finance to financial inclusion outcomes. And going beyond the descriptive comparison, the study gives a causal and trade-off analysis, which is especially in relation to efficiency vs. inclusiveness and centralization vs. flexibility.

2. IMPORTANCE OF THE STUDY

The importance of this research study is that this research method will help in establishing the changing role of Islamic finance in the response to the current socio-economic issues. Although the analysis of Islamic financial institutions has been typically approached through the prism of commercial banking, the past decades have witnessed a growing interest in these financial institutions in terms of advancing financial inclusion, through the lens of Islamic social financially advanced instruments such as zakat, waqf and Islamic microfinance (Hudaefi *et al.*, 2021; Razak, 2024). The main principles of Islamic finance are based on the principles of justice (adl), mutual cooperation (ta'awun), and the unacceptability of practices exploiting others, like riba. These values go hand in hand with the aims of inclusive financial systems and sustainable development. Accordingly, Islamic finance offers a special set of principles to achieve just wealth distribution and social-economic well-being (Iqbal and Mirakhor, 2011). Moreover, the digitalization of financial services has also led to new possibilities to reach and make Islamic financial inclusion more effective. The fusion of the Islamic fintech solutions, including the digital payment systems, crowdfunding platforms, and mobile-based financial services can also make accessibility to solutions and specifically financial services more accessible and efficient, especially to underserved groups (Huda *et al.*, 2021; Yue *et al.*, 2022).

The research is especially significant because it will fill the gap between the policy development and the actual implementation of the Islamic financial inclusion. Comparing the framework of the centralized model in

Malaysia and the decentralized scheme in Indonesia, the research provides insights into how institutional setups, administration systems and cultural backgrounds impact financial inclusion results. Further, the researchers point out the trade-offs between efficiency and inclusiveness as well as centralization and flexibility. These trade-offs are of great essence to policy makers, regulators and practitioners who want to design effective and sustainable strategies of financial inclusion in systems of Islamic finance. In the final analysis, this study contributes to the overall discourse in that it provides a more integrated and analytical perspective on the issue of Islamic financial inclusion, beyond its descriptive approaches.

3. LITERATURE REVIEW

3.1. Financial Inclusion: Concepts and Theoretical Foundations

It is not a secret that financial inclusion is one of the major factors in economic growth and social equity. It means provision of accessible, affordable and appropriate financial services to all groups in society and especially those that are underserved. According to the definition of the World Bank, financial inclusion is access to useful and affordable financial products and services provided in a responsible and sustainable manner (World Bank, 2022). Theoretically, financial inclusion has its foundation in both the development economics and institutional theory which focus on the role of financial systems in alleviating poverty, increasing productivity, and fostering inclusive growth. Empirical studies indicate that the access to financial services may lead to income stability, entrepreneurships, and resiliency among low-income households (Demirgüç-Kunt *et al.*, 2018). Nevertheless, other structural impediments like price, reliability, and mistrust still encumber financial engagement, especially in the developing economies.

3.2. Islamic Finance and Financial Inclusion

The Islamic finance offers a value-based financial system which corresponds to the goals of financial inclusion. It is based on such principles as risk-sharing, the prohibition of riba (interest) and ethical investments, which can lead to socio-economic justice and equitable distribution of wealth. These principles can be related to Maqasid al-Shariah that focus on enhancing welfare and reducing poverty (Iqbal and Mirakhor, 2011). Islamic financial institutions (IFIs) are very critical in promoting financial inclusion through offering Shariah-abiding financial products to serve people who are not incorporated into the mainstream conventional financial systems. Marginalized populations and socio-economic development are specifically addressed by such instruments as zakat, waqf, and

Islamic microfinance, which are relevant in particular (Abdullah, 2018). Recent research has also indicated that the success of Islamic financial inclusion is not only linked to the product innovation, but also, to the institutional integration and regulatory alignment. As an illustration, a study by Shamimi Mohd Zulkarnaini and Rusni Hasan shows that the outcomes of financial inclusion depend greatly on the framework of governance, the alignment of policies, and the incorporation of Islamic social finance in the financial systems of individual countries (Zulkarnaini and Hasan, 2025). Their results emphasize the criticality of balancing institutional designs in line with financial inclusion targets in order to improve both access and sustainability.

3.3. Islamic Social Finance and Inclusion Outcomes

Social finance instruments in the Islamic world such as zakat, waqf and sadaqah have increasingly come into focus as effective instruments in promoting financial inclusion. By their very nature, these instruments are redistributive by design, and are intended to provide support to vulnerable populations which complement the formal financial systems. Scholarly research points to the fact that cooperation between Islamic social finance and formal financial institutions could greatly improve the level of outreach and long-term sustainability (Hudaefi *et al.*, 2021). Zakat and waqf in Malaysia are institutionalized with state religious authorities allowing structured and transparent mechanisms of distributing zakat and waqf. Conversely, Indonesia has assumed a relatively decentralized system of involving numerous actors, thereby resulting in dissimilarities in efficiency and government. Emerging models like waqf-based financing and zakat-linked microfinance have been discovered as the promising mechanism to expand the financial inclusion and ensure the realization of the sustainable development goals (Razak, 2024). Their effectiveness, however, is based on the quality of governance, the coordination of institutions, and the regulation.

3.4. Islamic Fintech and Digital Financial Inclusion

Due to the emergence of Islamic fintech, the potential of financial inclusion has significantly increased with the use of digital technologies, including mobile banking, digital payments, crowdfunding, and blockchain. These innovations will decrease transaction costs, increase accessibility, and make the delivery of financial services feasible to remote and underserved populations. Research suggests that Islamic fintech could help enhance financial inclusion by offering easy-to-access and Shariah-compliant

financial services (Huda *et al.*, 2021). Malaysia has become a pioneer in this room with sound regulatory policies and environments conducive to innovations. On the contrary, the digital ecosystem in Indonesia is only taking shape, with inequality in infrastructure and digital literacy, especially in the rural communities. Despite the potential, digital financial inclusion faces numerous challenges, such as a risk of cyberattacks, regulatory gaps, and uneven access to digital infrastructure (Yue *et al.*, 2022). These issues highlight the importance of coordinated policy and governance structures.

3.5. Governance, Institutional Structures, and Financial Inclusion

Institutional arrangements and governance are key key bloodlines of financial inclusion. Institutional theory posits that good governance arrangements contribute to increased coordination, transparency and efficiency of financial systems. The system of the Islamic finance in Malaysia is marked with centralized executive under the Bank Negara Malaysia, which brings regulatory transparency and standardization. Such a centralized format helps in aligning the policy, and the large mass operations of financial inclusion programs can be deployed. Conversely, Indonesia is put in an environment of loose regulations that involve Bank Indonesia and Otoritas Jasa Keuangan, where flexibility and interaction with community members is encouraged even when this leads to a hodgepodge implementation and notable lack of consistency in supervision. Building upon it, Zulkarnaini and Hasan (2025) believe that the nature of governance structures has a significant impact on financial inclusion outcomes. Centralized systems are more likely to be more efficient and scalable, whereas decentralized systems tend to be more inclusive and embed within cultures but may have difficulty in coordination. Empirical studies on Islamic microfinance institutions in Indonesia support these findings, which also highlight their capability to reach large populations and their control limitations (Ginjar and Kassim, 2021; Ascarya and Suharto, 2022).

3.6. Research Gap and Contribution

Although the available literature has also explored the topics of Islamic financial inclusion, Islamic fintech and social finance instruments, most studies have been based on the perspectives of single countries or descriptive studies. The very few studies that have been conducted in comparing Malaysia and Indonesia have often incorporated governance structures, digital ecosystems, and Islamic social finance all as part of a single analytical platform. Notably, a recent bibliometric outlook study of the topic of financial inclusion and Islamic finance research trends by Shamimi Mohd

Zulkarnaini and Rusni Hasan indicates that the existing papers are so concentrated in conceptual discourse, with a strong foundation in Islamic microfinance, as well as in general inclusion frameworks, with limited emphasis on comparative institutional analysis and integrated governance-fintech-social finance models (Zulkarnaini and Hasan, 2025). The research also notes the literature is divided in such a way that all of the three areas of governance, digitalization, and Islamic social finance remain split and examined individually; instead of being explored as three related areas of investigation.

This divide suggests changing to an analytical method that is more inclusive and expansive in the study so as to capture the interplay between institutional structures, technological innovation, and social finance mechanisms. In response to this weakness, the current research paper establishes a combined comparative framework that associates governance, digital financial ecosystems and Islamic social finance to the outcomes of financial inclusion. It also makes a contribution by providing a causal and trade-off analysis especially when compared to centralization and flexibility as well as efficiency and inclusiveness.

4. RESEARCH METHODOLOGY

The research operates under the approach of qualitative comparative case study to examine the ways in which Islamic Financial Institutions (IFIs) in Indonesia and Malaysia are putting into practice financial inclusion strategies. It is an exploratory/explanatory design that will provide an in depth study of institutional arrangements, governance structures, and policy mechanisms in their real world context. This method is also aligned with the case

study approach that has been elucidated by Robert K. Yin, which is especially applicable to the research of modern institutional phenomena. A qualitative approach is embraced as the study aims to know the complex interactions between governance, digitalization and Islamic social finance that cannot be fully identified using purely quantitative methods. According to John W. Creswell, a qualitative inquiry suits the analysis of the context-specific and process-oriented phenomena. Malaysia and Indonesia are chosen since they are diverse in their Islamic finance ecosystems. Malaysia is a centralized where the policy intends to represent the Malayan better or worse than Indonesia who is decentralized where the policy intends to represent the Malayan better or worse than the Indonesian who is decentralized.

The research design, as presented in Table 1, combines various sources of data and used a structured analytical framework to guarantee the research design has methodological rigor.

4.1. Data Sources and Selection Criteria

The study is based on secondary data, collected from a range of credible and authoritative sources to ensure reliability and triangulation. These include:

- National policy documents (e.g., financial inclusion frameworks, Shariah governance guidelines)
- Institutional reports from Islamic banks and microfinance institutions
- Peer-reviewed academic publications indexed in Scopus and Springer

Table 1: Research Methodology Overview

Component	Description
Research Approach	Qualitative, comparative case study
Research Design	Exploratory and analytical, focusing on institutional structures, governance, and financial inclusion strategies
Case Selection	Malaysia and Indonesia selected due to contrasting Islamic finance ecosystems (centralized vs decentralized)
Data Type	Secondary data
Data Sources	Policy documents, institutional reports, peer-reviewed journals (Scopus, Springer), international organization reports (World Bank, IsDB, IMF)
Time Frame	2015–2024
Inclusion Criteria	Relevant to Islamic finance and financial inclusion; credible academic or institutional sources; country-specific focus
Exclusion Criteria	Non-academic sources (blogs, opinion articles), irrelevant countries, duplicated sources
Analytical Method	Thematic analysis
Theoretical Lens	Institutional theory and stakeholder theory
Research Objective	To compare governance, institutional models, and digital integration in shaping Islamic financial inclusion

Sources: Authors' own based on case study methodology articulated by Robert K. Yin.

- Reports from international organizations such as the World Bank, Islamic Development Bank (IsDB), and International Monetary Fund (IMF)

The review period spans 2015 to 2024, capturing recent developments in Islamic fintech, regulatory frameworks, and financial inclusion policies. To ensure the rigor of the analysis, the study uses clear inclusion and exclusion criteria. Inclusion criteria included that they should be about Islamic finance and financial inclusion, focused on Malaysia and Indonesia, and published in credible academic or institutional journals. Sources were also excluded on basis of lack of academic credibility, duplicative and lack of methodological transparency.

4.2 Data Analysis Procedure

The thematic analysis is used in the study to identify and analyze the collected data. This approach is based on the systematic approach suggested by Virginia Braun and Victoria Clarke, as it will be possible to identify patterns and themes within qualitative data sets with the help of this approach.

The analysis was performed at the expense of three stages:

1. Open coding where main concepts and repetitive ideas concerning the governance, digital finance and Islamic social finance were discovered;
2. The systematization into more general, thematic concepts like regulatory frameworks, institutional models and implementation strategies;
3. Particular coding where the themes were incorporated into main analysis levels that form the basis on comparative frame.

To maximize reliability the coding was done systematically and cross-validation of at least two sources of data.

4.3 Analytical Framework

The analysis is informed by an unified analytical framework which investigates the relations between three main dimensions:

- Forms of governance (centralized or decentralized)
- Integration of Islamic social finance (zakat, waqf, microfinance)
- Digital financial ecosystems (Islamic fintech and digital platforms)

The combination of these dimensions has an impact on financial inclusion outcomes and in this case, both in terms of access, outreach, usage, and sustainability. The moderating factors included in the framework are institutional efficiency, regulatory coordination and socio-cultural embeddedness.

FINDINGS

The comparative analysis reveals distinct differences between Malaysia and Indonesia across key dimensions of Islamic financial inclusion.

As is summarized in Table 2, Malaysia has a highly coordinated and centralized system, with strong regulatory oversight, institutional integration, and high digital infrastructure. Financial inclusion programs are hardwired into the national systems of policy and are enabled by formal financial institutions, allowing very high levels of scalability and efficiency. Indonesia in its turn follows the more decentralized and community-oriented model, with most of its financial systems being based around Baitul Maal wat Tamwil (BMTs) and pesantren-centered financial structures. This model will increase accessibility and trust, especially between the rural and underserved populations, but there is a challenge that involves governance fragmentation and uneven adoption of digital technologies.

Table 2: Comparative Findings – Malaysia vs Indonesia

Dimension	Malaysia	Indonesia
Governance Structure	Centralized, strong regulatory coordination (BNM, SAC)	Decentralized, multiple regulators (BI, OJK, DSN-MUI)
Institutional Model	Top-down, bank-led approach	Bottom-up, community-based (BMTs, pesantren)
Islamic Social Finance	Integrated with formal financial system	Community-driven, less standardized
Digital Integration	Advanced Islamic fintech ecosystem	Uneven, limited in rural areas
Scalability	High due to structured system	Limited due to fragmentation
Financial Inclusion Outcome	High access and usage rates	Moderate, strong rural outreach but inconsistent

Sources: Authors' own.

Table 3: Key Financial Inclusion Indicators

Indicator	Malaysia	Indonesia	Reference
Financial Inclusion Rate	~85–90%	~75–80%	(Demirgüç-Kunt <i>et al.</i> , 2018; World Bank, 2021)
Islamic Banking Penetration	High (~30%+)	Moderate (~10%+)	(Bank Negara Malaysia, 2023; OJK, 2023)
Digital Financial Adoption	High	Moderate to low (rural gap)	(Huda <i>et al.</i> , 2021; Yue <i>et al.</i> , 2022)
Microfinance Outreach (BMTs)	Limited	Extensive	Ascarya & Suharto (2022) and Ginanjar & Kassim (2021)
Zakat/Waqf Integration	Institutionalized	Fragmented	Hudaefi <i>et al.</i> (2021) and Razak (2024)

Sources: Authors' own.

To add to the qualitative results, Table 3 will provide important financial inclusion indicators. Financial inclusion and penetration of Islamic banking is higher in Malaysia, with high adoption of fintech. Having good outreach with high microfinance institutions, but during moderate overall inclusion rates due to structural and technological restrictions, Indonesia does show. In general, the results show that the model of Malaysia is more efficient in the attainment of scalability and institutional efficiency, whereas the Indonesia model is more effective in the achievement of the grassroots inclusion and community engagement.

DISCUSSION

The variations that are visible between Malaysia and Indonesia, are not just descriptive qualities but can be explained by underlying institutional and governance processes. The country strengths identified in Table 4, include centralized form of governance structure that ensures consistency in the regulations, uniformity in practices, and compatibility with digital financial services. These aspects lead to

increased scalability and enhanced institutional performance. The model can however constrain the ability to work with informal and marginalized populations, especially in the rural setting.

Conversely, Indonesia's decentralized model leverages community-based institutions to enhance accessibility and cultural embeddedness. This approach promotes trust and inclusiveness but causes inefficiencies since governance is fragmented, lacks regulation quality, and is technologically inefficient. The causal trends are further pointed out in Table 5 which acts as a flagposter of identify key trade-offs between the two models. Malaysia system puts more emphasis on efficiency, scalability, and standardization whereas Indonesia puts more emphasis on flexibility, inclusiveness and local adaptability. These trade-offs are indicative of greater institutional restrictions and decisions on policy that influence the result of financial inclusion.

Importantly, the findings suggest that neither model is inherently superior; rather, each reflects different priorities and structural conditions. A more leveled and

Table 4: Strengths and Limitations

Country	Strengths	Limitations
Malaysia	Strong governance, regulatory clarity, digital advancement, scalability	Limited grassroots engagement, urban-centric outreach
Indonesia	Strong community trust, high rural outreach, flexible model	Weak governance standardization, limited digital capacity, scalability issues

Sources: Authors' own.

Table 5: Causal Analysis and Trade-offs

Factor	Malaysia (Centralized Model)	Indonesia (Decentralized Model)
Efficiency	High (standardized systems)	Lower (fragmented structure)
Inclusiveness	Moderate (less grassroots reach)	High (community embeddedness)
Scalability	Strong	Limited
Flexibility	Low	High
Key Trade-off	Efficiency vs inclusiveness	Flexibility vs standardization

Sources: Authors' own.

sustainable road to Islamic financial inclusion may be with a hybrid approach that would integrate centralized regulatory capacity with decentralized engagement with communities.

CONCLUSION

This paper has shown that the institutional forms, regime structures, and the degree of digitalization of various institutions shape Islamic financial inclusion in Malaysia and Indonesia. The central and policy-based model designed to support scalability and efficiency while the decentralized and community-based model was designed to support inclusiveness and social trust. The study also provides a contribution to the literature by providing an analytical framework thereby linking governance, digital finance, and Islamic social finance to the outcomes of financial inclusion. It also emphasizes the need to have an efficient balance between efficiency and inclusiveness when designing financial inclusion strategies.

Policy Recommendations

In light of the comparative results the following policy measures are suggested:

1. Strengthening Governance and Regulation

Malaysia must remain in the process of perfecting regulatory frameworks through which inclusive finance can be enhanced by Islamic banks, and policy instruments put in place to encapsulate and support small-scale Islamic microfinance providers. Indonesia should improve the institutional governance on BMTs and the collective of privately employed zakat collectors. This incorporates emerging a national supervisory framework, with a mandatory reporting and licensing and the Shariah auditing standards.

2. Promoting Institutional Collaboration

More systematic collaborations between Islamic banks and the state zakat agencies, waqf boards, and fintech providers should be formulated in Malaysia in order to expand access to inclusive programs. Indonesia needs to encourage BMTs to work with the government and Islamic banks to boost capital flows, training, and digitization support to microfinance activities.

3. Enhancing Digital Financial Inclusion

If Malaysia should implement more use of Islamic digital banks, improve the conditions of data sharing, use e-zakat, waqf crowdfunding, and AI-based microcredit scoring tools. To support the development of digital infrastructure in rural areas, Indonesia needs

to invest in digital literacy, rural internet networks, and technical grants to digitalize BMTs, such as developing common infrastructures to Islamic microfinance.

4. Integrating Islamic Social Finance into National Development

Islamic social finance should be institutionalized by both countries as a component of their financial sector development strategies and sustainable development goals (SDG) strategies and goals, in particular, SDG 1 (No Poverty) and SDG 8 (Decent Work and Economic Growth). Create new financing tools, including social impact sukuk, zakat-linked micro-insurance (takaful), and digital waqf wallets to mobilize funds to support health, education, and financing of micro-enterprises.

5. Cross-Country Learning and Regional Cooperation

Encourage knowledge-sharing platforms among Bank Negara Malaysia, Bank Indonesia, OJK as well as zakat / waqf boards, to share best practices in regulation, Shariah governance and inclusive finance models. Encourage joint programs through ASEAN financial inclusion working groups, IDB/IsDB platforms, and academic institutions to conduct impact assessments, pilot programs, and policy experimentation in Islamic finance.

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