

THE DEVELOPMENT OF ISLAMIC FINANCIAL INSTRUMENT: OPPORTUNITIES AND CHALLENGES

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Abstract

Islamic financial instruments are an integral component of the global economic system, particularly in countries with a majority Muslim population. The growing Muslim population and increased awareness of Islamic compliance are driving the use of Islamic financial instruments as an alternative to conventional options. This study aims to explore the development, challenges, and opportunities of Islamic financial instruments using a descriptive qualitative research approach. Data collection techniques involve literature review with secondary data sourced from academic journals, official publications, and reports on Islamic financial developments from various institutions. The results of this study indicate that there are various Islamic financial instruments, such as *murabahah* and *mudharabah*, used for Islamic funding instruments, as well as other instruments for Islamic financing instruments, Islamic savings and deposit instruments, Islamic investment instruments, Islamic insurance instruments, and social Islamic finance instruments. There is also the development of Islamic financial instruments like green sukuk and Islamic financial technology. However, this development faces challenges, including regulatory and policy issues, liquidity challenges, and others. It is hoped that this research will contribute to the expansion of Islamic financial instruments and raise awareness among the public, particularly among academics and practitioners, to address the challenges in Islamic finance.

Keywords: Islamic Financial Instruments, Development of Islamic Financial Instruments, Islamic Finance Challenges

Abstrak

Instrumen keuangan Islam merupakan komponen integral dalam sistem ekonomi global, terutama di negara-negara dengan mayoritas penduduk Muslim. Peningkatan populasi Muslim dan kesadaran akan kepatuhan syariah mendorong penggunaan instrumen keuangan syariah sebagai alternatif konvensional. Penelitian

ini bertujuan mengeksplorasi perkembangan, tantangan, dan peluang instrumen keuangan syariah dengan menggunakan pendekatan penelitian kualitatif deskriptif. Teknik pengumpulan data menggunakan studi literatur dengan data sekunder yang diperoleh dari jurnal akademik, publikasi resmi, dan laporan perkembangan keuangan syariah dari institusi. Hasil penelitian ini menunjukkan bahwa terdapat berbagai instrumen keuangan syariah, seperti murabahah dan mudharabah yang digunakan untuk islamic funding instruments, serta instrumen-instrumen lainnya seperti islamic financing instruments, islamic savings and deposit instruments, islamic investments instruments, islamic insurance instruments, dan islamic finance instrumen. Terdapat juga pengembangan instrumen keuangan Islam seperti green sukuk ataupun Islamic financial technology, namun perkembangan keuangan syariah ini mengalami tantangan, seperti tantangan regulasi dan kebijakan, tantangan likuiditas, dan lainnya. Diharapkan penelitian ini dapat berkontribusi untuk memperluas instrumen keuangan Islam, serta dapat meningkatkan kesadaran bagi masyarakat, khususnya kalangan akademisi dan praktisi untuk menghadapi tantangan keuangan Islam.

Kata Kunci: Instrumen Keuangan Islam, Pengembangan Instrumen Keuangan Islam, Tantangan Keuangan Islam

Introduction

Islamic financial instruments are an inseparable part of the global financial economic system, especially for countries with a majority Muslim population. The significant yearly increase in the Muslim population and the positive correlation with the awareness of adherence to Sharia principles in daily life encourage people to consider Islamic financial instruments as both a necessity and an alternative to the existing conventional financial instruments. This is supported by data from the Islamic Financial Development Indicator Report (IFDI), which shows positive growth in the global Islamic finance industry with total asset growth of 17%, reaching USD 4 trillion in 2021, and is expected to continue increasing to USD 5.9 trillion by 2026. Malaysia ranks first in the average IFDI score for 2022 with a score of 113, followed by Saudi Arabia and Indonesia in third place. There are several indicators used to determine the IFDI score, namely Financial Performance, Governance, Sustainability, Knowledge and Awareness, Environmental, Social, and Governance (ESG), and Islamic Financial Technology (London Stock Exchange Group, 2023).

By sector, banking remains the largest sector in the Islamic finance industry. The proportion of assets generated from the Islamic banking sector reached US\$ 2.756 trillion, accounting for 70% of the total assets of the Islamic finance industry

in 2021. The growth of outstanding Islamic financial assets is also notable in the capital market sector, specifically in the issuance of Islamic bonds (sukuk), which contributed 18% to the Islamic finance industry with total assets of US\$ 713 billion and the highest number of institutions/instruments at 4,426. Other capital market instruments such as mutual funds contributed 6% or US\$ 238 billion, followed by Islamic Financial Institutions like Islamic cooperatives and *Baitul Maal wat Tamwil* (BMT), as well as takaful, each contributing 2% with total assets of US\$ 73 billion (Otoritas Jasa Keuangan, 2023a).

Table 1
 Growth of Global Islamic Financial Assets

	Islamic Banking	Islamic Bonds	Islamic Mutual Fund	Other Islamic Financial Institution	Islamic Insurance
Total Asset (US\$ Miliar)	2,765	713	238	169	73
Portion	70	18	6	4	2
Number of Institutions/Instruments	566	4,426	1,903	778	335

Sumber: OJK-Islamic Finance Development Report (IFDI) 2022

Previous research has been conducted by Andiansyah et al., (2022) on the “Impact of Islamic Financial Instruments on Indonesia's Economic Growth”, using the Autoregressive Distributed Lag (ARDL) analysis tool. They found that all Islamic financial instruments had a negative impact on economic growth in the short term but had a positive impact in the long term, except for Islamic mutual funds and Islamic bank financing. Furthermore, Prasetyo et al., (2016) in their article titled "Islamic Business: Islamic Ethics and Islamic Financial Instruments - A Meta-Analysis Approach," reviewed various Islamic financial instruments in Islamic business. The conclusion drawn was that Islamic business should be based on the Qur'an and Hadith and should promote welfare and prosperity for the community. These two studies serve as a foundation for this research to comprehensively explore Islamic financial instruments and the developments that can be made to enhance Islamic financial assets both nationally and globally

Based on previous research and the data in Table 1, this study aims to explore and analyze the developments in Islamic financial instruments, as well as to examine the challenges and opportunities for the future development of Islamic financial instruments. It is hoped that this paper will contribute to both

academics and practitioners in the field of Islamic economics regarding Islamic financial instruments, and help identify opportunities, analyze market dynamics, and overcome barriers to the development of Islamic financial instruments in the future.

Methods

The research uses a qualitative approach with a descriptive method to identify and analyze Islamic financial instruments and their development. The data collection technique involves a literature review by sourcing and reconstructing information from various sources. The data used are secondary sources, such as books, academic journals, official publications, and financial reports from institutions. The collected data are then analyzed through several processes, including data reduction, data presentation, and drawing conclusions and verifying data. The data are analyzed manually by categorizing and interpreting the information based on the reading materials and understanding acquired. Conclusions are drawn based on the literature review and analysis of the information collected.

Research Results and Discussion

Financial Instruments

According to the Indonesian Institute of Accountants (IAI) in PSAK No.50, a financial instrument is a contract that creates a financial asset for one entity and a financial liability or equity instrument for another entity (Ikatan Akuntan Indonesia, n.d.). In other words, a financial instrument can be defined as a tool, agreement, or financial product that helps an individual to gain profit, manage wealth, or secure the financial assets they own.

In practice, financial instruments involve obligations on one party, such as a commitment to make certain payments, while the other party receives benefits such as rights to those payments or proof of ownership in a company (Mesak, 2023). There are two types of financial instruments based on their value (Kenton, 2024):

1. Cash Instruments

Cash instruments are financial instruments whose value is determined by mutual agreement between two parties and have physical evidence of ownership.

a. Cash

Cash is one of the means of exchange used for transactions between buyers and sellers. It can be in the form of paper money or coins, with tangible physical evidence and exchange value according to the standards established by mutual agreement. Simple examples of cash include a Rp. 100,000 banknote and a Rp. 1,000 coin.

b. Check

A check is an order to a bank to pay a specified amount of money to the person named on the check. Generally, a check is a paper document issued by a bank on behalf of its customer. There are several types of checks. The first is a bearer check (Aan Order), which specifies the name of the payee on the check. The second is an open check (Aan Tonder), which does not specify the name of the payee. The third type is a cashier's check, which is a check whose payment is limited to account transfers only. The last type is a crossed check, which is a type of bank check that is limited to specific parties who are able to receive and issue checks.

c. Giro

Similar to a check, a bank draft is an order issued by a bank on behalf of its customer. However, a bank draft instructs the bank to transfer a specified amount of money from one account to another. There are two types of bank drafts: first, a regular bilyet giro; second, an inkaso bilyet giro.

d. Securities

Securities are financial instruments that are documents representing ownership in a company or debt issued by the government. Securities are issued by companies or governments to raise funds from the public. Examples of securities include bonds and stocks.

2. Derivatives Instrument

If the value of cash instruments is determined by the market, then derivative instruments are financial contracts or agreements whose value is determined based on the performance of assets or indices of other commodities. Financial instruments that fall under derivatives include:

a. Options

Options provide the right to buy or sell an asset at a specified price on or before a set deadline. An option is a contract signed by the buyer and the seller of the option. Options are divided into two types: call options and put options.

A call option example is when someone wants to buy a house in a certain location but first wants to observe the area's development in the future. The person can create a call option with the developer to purchase the house within the next three years at a price of Rp100,000,000. The developer will ask for a down payment, and if within the next two years the area around the house has developed and the house price doubles, the person will still pay the initial agreed price. However, if the area does not develop, the person can buy the house at the market price at that time.

Next, an example of a put option is when Mr. A buys an option for asset A, which is being traded at a price of Rp500,000, with an agreed strike price of Rp470,000. In this case, even if the price of asset A drops to Rp400,000, Mr. A can still sell the asset at the agreed price of Rp470,000. However, to do this, Mr. A must pay a premium of Rp50,000. When calculated, Mr. A managed to avoid a loss of Rp20,000 compared to if he did not use the put option.

b. Futures Contracts

A futures contract is an agreement between a buyer and a seller to trade a commodity at a predetermined price and date set at the start of the contract. This means the buyer does not need to worry about market price fluctuations. Futures contracts are commonly used for commodities with highly fluctuating prices that are essential to the market.

An example, the oil company plans to produce 1 million barrels of oil next year, which will be ready in 12 months. Let's assume the current price of oil is 75 USD per barrel. The company could produce the oil and then sell it at the market price for a transaction one year from now. Given the volatility in oil prices, the market price at that time could be very different from the current price. If the oil price is expected to increase next year, the oil company might choose not to lock in the current price with a futures contract. However, if the oil company believes that 75 USD per barrel is a favorable price, they could lock in that price by selling through a futures contract. This way, the potential profits can be secured regardless of future oil price movements.

For example, let's say that the futures contract for oil is priced at 78 USD per barrel one year from now. With this contract, in one year the company is obligated to deliver 1 million barrels of oil and is guaranteed to receive a revenue of 78 million USD. The price of 78 USD per barrel is assured, regardless of the market price of oil at that time."

c. Swaps

A swap is a contract to exchange cash flows in the future. This contract is signed by both parties, the buyer and the seller of the swap. Examples of swap contracts include interest rate swaps, currency swaps, and credit default swaps.

An example, two companies, Company A and Company B, each have a \$1 million loan with different interest rates; Company A pays a fixed interest rate of 5%, while Company B pays a variable interest rate (e.g., LIBOR + 2%). They agree to a swap, where Company A will pay Company B's variable interest rate, and Company B will pay Company A's fixed interest rate. This way, Company A can reduce its risk if interest rates rise, while Company B can benefit if interest rates fall.

In addition to being categorized by their value, instruments or contracts can also be classified based on their functions and economic purposes. Contracts (instruments) in business and commercial transactions can be categorized into four types (Rokhlinasari & Widagdo, 2023):

1. Transactional Contracts

These contracts relate to the real economy sector and facilitate the exchange, sale, and trade of goods and services. The contracts are based on trading or exchange activities, either directly or indirectly, and can be executed in cash or on credit. Such contracts or instruments can create funding and investment opportunities, making them central to a broader economic and financial system.

2. Financing Contracts

Financing contracts are designed to create and expand credit, facilitate the financing of transactional contracts, and provide a channel for capital formation and resource mobilization between investors and entrepreneurs. The uniqueness of financing contracts is that they do not involve debt. The purpose of financing contracts is to fund transactional contracts in the form of trade finance, asset-backed securities, and equity partnerships. Regarding risk, financing contracts offer a range of risks depending on the type of contract, from safer options like securities or investments to higher-risk ventures such as venture capital or investments in highly risky companies.

An example, Company XYZ has signed a financing contract with Bank ABC to fund a new factory construction project. In this contract, Bank ABC will provide Rp10 billion with a fixed interest rate of 8% per year, which Company XYZ will repay over a period of 5 years through monthly installments. As collateral, Company XYZ will submit the land and building certificates for the construction as security.

Additionally, the contract includes a penalty clause for late payments and provisions for early repayment without penalty if Company XYZ achieves sufficient cash flow

3. Intermediary Contracts

Intermediary contracts are designed to make transactional contracts more transparent and efficient. The mechanism of intermediary contracts involves partnering with others who have the necessary skills under profit-sharing agreements. The profits are distributed according to the agreement. However, these contracts are considered high-risk because it is difficult to predict whether the efforts of the other party will be profitable or result in a loss.

4. Social Welfare Contracts

These contracts are based on the benefits that individuals can provide to society to achieve welfare and happiness. The main goal of social welfare contracts is not personal profit or gain but the well-being of the broader community.

Islamic Financial Instruments

While conventional financial instruments use the term "contract", Islamic financial instruments use the term "akad". Similar to a contract, an akad requires specific terms and conditions that must be considered to make decisions. An akad is accepted and deemed valid according to Islamic law if the terms of the akad do not include anything that is prohibited by Sharia.

1. Islamic Funding Instruments

a. *Mudharabah*

This Islamic financial instrument takes the form of a partnership (*akad*) between the capital provider (*shahibul maal*) and the fund manager (*mudharib*) who has the expertise. In *mudharabah* financial instruments, it falls under intermediary contracts, involving a profit-sharing system agreed upon at the outset of the contract. *Mudharabah* contracts are high-risk because if losses occur and are not due to negligence or fault of the fund manager, the capital provider will bear the losses.

Mudharabah has two main types, *Mudharabah Mutlaqah*, namely an unrestricted partnership where the capital provider grants the fund manager the freedom to manage the funds without specific constraints regarding location, method, or investment object. *Mudharabah Muqayyah*, namely a restricted partnership where the management of funds is specified by the capital provider in terms of location, method, and investment objects. An example, in Islamic banking, an example of a *mudharabah* transaction can be illustrated as follows:

Company XYZ forms a partnership with Bank Syariah DEF through a *mudharabah* contract to fund its business expansion. Bank Syariah DEF provides capital of Rp2 billion as the investor, while Company XYZ acts as the business manager. The profits from this business expansion will be shared between both parties as agreed, for example, 70% for Company XYZ and 30% for Bank Syariah DEF. If the business incurs losses, Bank Syariah DEF will bear the loss according to the proportion of the capital provided, while Company XYZ will not bear the loss except in cases of negligence or breach of contract.

According to the Financial Services Authority (OJK) report, in 2022, the financing based on *mudharabah* akad amounted to Rp10.77 trillion. This increased to Rp12.45 trillion in 2023 (Otoritas Jasa Keuangan, 2024).

b. *Musyarakah*

Like *mudharabah*, *musyarakah* is also a partnership akad between capital providers and fund managers. However, the main difference is that in *musyarakah*, the fund manager's own capital is mixed with the financing for specific business ventures, whether they are existing or newly started. The fund manager will then repay the borrowed capital along with the agreed-upon profit-sharing, either in installments or as a lump sum. *Musyarakah* financing can be provided in various forms, including cash, cash equivalents, non-cash assets, or intangible assets such as certifications and patents.

In *musyarakah*, losses are shared proportionally and reasonably according to the capital contributed. This differs from *mudharabah* due to the involvement of the fund manager's own capital. In permanent *musyarakah*, the amount of capital will be determined as per the contract and will last until the end of the *akad* period. In decreasing *musyarakah*, the capital provider will gradually repay the financing until they become self-sufficient and no longer need additional funding.

In a *musharakah* financing arrangement, for example, Company ABC and Bank Syariah DEF agree to collaborate on a shopping center construction project. Company ABC provides 60% of the required capital, amounting to Rp12 billion, while Bank Syariah DEF contributes 40%, or Rp8 billion. The profits from the project will be distributed according to the investment proportions, with 60% going to Company ABC and 40% to Bank Syariah DEF. If the project incurs losses, the losses will also be borne according to the respective investment proportions. Both parties are actively involved in the project management and share the risks and profits fairly.

Musyarakah financing is the most widely used akad for financing distribution. According to the Financial Services Authority (OJK) report,

musyarakah financing reached Rp229.85 trillion in 2022. In 2023, this amount increased to Rp282.51 trillion (Otoritas Jasa Keuangan, 2024).

c. *Murabahah*

Murabahah is a sale and purchase contract. It is based on an agreement between the seller and the buyer, either with or without an order, and allows for a markup on the sale price of goods. In practice, this is common in Islamic banking, where the bank purchases the goods desired by the customer. The goods are then marked up by the bank before being sold back to the customer. The bank will require the customer to provide collateral for the *murabahah* receivables, and the customer will repay the amount through installments. If the customer fails to settle the debt despite being able to do so, the bank may impose a penalty. This approach aims to discipline the customer to adhere to debt repayment, with the penalties being used for social funds (*qardhul hasan*).

The initial contract price (*akad*) in *murabahah* is the selling price of the goods, while the purchase price is the marked-up price offered by the bank, which must be disclosed. Any discounts or reductions are to be negotiated based on the agreed terms.

Murabahah conducted through orders may be binding or non-binding. Binding means that the buyer cannot cancel the order once the bank has purchased the *murabahah* asset. However, if the asset's value decreases before delivery to the customer, the loss will be borne by the seller, in this case, the Islamic bank.

An example, Company XYZ needs capital to purchase new production machinery. Bank Syariah DEF agrees to buy the machinery for Rp1 billion and then sell it to Company XYZ with a 15% markup, making the selling price Rp1.15 billion. Company XYZ will pay Rp1.15 billion in monthly installments over 3 years without interest, in accordance with the Islamic principle that prohibits *riba*. As collateral, Company XYZ provides company assets. This contract ensures that the bank's profit is secured without interest, as per the initial agreement.

Murabahah is the second most widely used *akad* after *musyarakah*. In 2022, *murabahah* was the most frequently used *akad* for financing, amounting to Rp251.41 trillion. In 2023, the increase in the use of *murabahah* was modest, rising by only 2.95% to Rp258.84 trillion (Otoritas Jasa Keuangan, 2024).

d. *Salam*

Salam is a purchase contract for goods with a deferred delivery by the seller (*musam alaihi*), but the payment is made at the beginning of the *akad*. The main

characteristic of *salam* is the seller's obligation to deliver the goods, which becomes a debt for the seller and must be fulfilled by the specified time.

In practice, this is implemented by Islamic banks acting as intermediaries between producers and buyers. This practice is known as parallel *salam*. In the first *akad*, the bank purchases goods from the supplier, and in the second *akad*, the bank sells these goods directly to the customer. The customer only needs to settle payment with the bank, and the goods are directly delivered by the supplier.

In Islamic banking, an example of a *salam* contract can be illustrated, company ABC enters a *salam* contract with Bank Syariah DEF for the purchase of raw materials. Under this contract, Bank Syariah DEF makes an advance payment of Rp500 million to Company ABC for raw materials to be delivered within 6 months. Company ABC commits to supplying the raw materials according to the agreed specifications and quantities by the specified date. This *salam* contract ensures that the advance payment is made by the bank, while the company is obligated to fulfill the order at a future date according to the agreed terms.

Financing using *salam akad* in the Islamic finance sector remains limited compared to other *akad*. It is the least used *akad*, with only Rp2.14 trillion utilized in 2022 (Otoritas Jasa Keuangan, 2024).

e. *Istishna*

Istishna is a sale and purchase agreement between the buyer and a producer who also acts as the seller. In this agreement, the buyer requests the producer to manufacture and supply goods according to the specifications requested by the buyer, and then sell them at an agreed-upon price. Payment for *istishna* transactions can be made in advance, in installments, or deferred until a specified time

In Islamic banks, *istishna* transactions can involve the bank acting as either the buyer or the seller. When the bank is the seller, it orders goods from another party to manufacture the requested items through *istishna*, known as parallel *istishna*. In parallel *istishna*, two separate agreements are required: the first is between the bank and the final buyer, and the second is between the bank and the subcontractor to produce the goods. The second agreement is made only after the first agreement between the bank and the buyer has been finalized.

In Islamic banking, an example of an *istishna* contract can be described as follows: Company XYZ enters an *istishna* contract with Bank Syariah DEF to manufacture and construct 100 residential units in a housing project. Bank Syariah DEF provides an advance payment of Rp10 billion to Company XYZ for purchasing building materials and covering production costs. Company XYZ commits to

completing the construction and delivering the 100 residential units within 18 months according to the agreed specifications in the contract. This *istishna* contract facilitates financing for projects requiring production or construction time, with the bank making an advance payment and the delivery of goods or services scheduled for the future.

Financing using *istishna akad* in Islamic finance reached Rp3.27 trillion in 2022. In the following year, the use of *istishna akad* increased to Rp4.07 trillion (Otoritas Jasa Keuangan, 2024).

2. Islamic Financing Instruments

a. *Ijarah* and *Ijarah Muntahiyah Bittamlik*

Ijarah is the payment made by the lessee (*musta'jir*) to the owner of the leased asset (*ma'jur*). In other words, *ijarah* represents compensation for the use of a leased asset. *Ijarah Muntahiyah Bittamlik* is a type of *ijarah* where, at the end of the lease period, ownership of the leased asset is transferred to the lessee.

According to the Islamic finance development report published by the Financial Services Authority (Otoritas Jasa Keuangan), financing using *ijarah akad* reached Rp8.33 trillion in 2022. In 2023, the use of *ijarah akad* increased to Rp9.85 trillion (Otoritas Jasa Keuangan, 2024).

b. *Qard* and *Qardh Hasan*

Qardh is a type of contract for a loan without any additional profit or interest charged to the borrower. It is based on the principles of mutual assistance and fairness. *Qardh al-Hasan* is a loan where the borrower is not required to repay the debt if they are genuinely unable to do so. Funds for *qardh al-hasan* typically come from social funds such as *zakat*, *infaq*, and *sadaqah*, which are intended for social welfare purposes.

According to the report from the Financial Services Authority (Otoritas Jasa Keuangan), financing using *qardh* contracts reached Rp14.31 trillion in 2022. The use of *qardh* contracts also increased in 2023, reaching Rp16.35 trillion (Otoritas Jasa Keuangan, 2024).

3. Islamic Savings and Deposit Instruments

a. *Wadiah*

Wadiah refers to safekeeping or custody. It involves a situation where goods are entrusted to another party for safekeeping, and the entrusted party is obligated to return the goods when requested by the depositor. *Wadiah* is divided into two types: *wadiah yad-mudhamanah* and *wadiah yad-amanah*. *Wadiah yad-mudhamanah* is a type of safekeeping where the goods deposited can be utilized

by the custodian. If any profit is generated from the use of the deposited goods, the custodian has the right to the profit. This is a fundamental difference from *wadiah yad-amanah*, where the custodian is not allowed to use the deposited goods and must return them as they are to the depositor.

Savings under *wadiah* accounts in Islamic financial institutions have been increasing annually. In 2021, the *wadiah* savings reached Rp98 trillion. By 2022, it had increased to Rp115 trillion, and in 2023, the amount reached Rp129 trillion (Otoritas Jasa Keuangan, 2024).

b. *Mudharabah* Savings

Mudharabah savings is an agreement between a customer and an Islamic bank regarding the funds deposited. These funds are invested in ventures that comply with Islamic principles, and the profits generated from these investments are shared with the depositor.

Mudharabah agreements are often used for non-profit sharing investment funds. In 2021, the use of non-profit sharing investment funds under *mudharabah* agreements amounted to Rp451 trillion. This increased to Rp504 trillion in 2022, and further grew to Rp555 trillion in the following year (Otoritas Jasa Keuangan, 2024).

c. Islamic Deposits

Islamic Deposits are instruments where customers deposit their funds for a specific period using either a *mudharabah* or *wadiah* contract. The profits from these deposits are shared according to the agreement made at the beginning.

d. *Sharf*

Sharf is a transaction involving the exchange of currency or monetary instruments. In Islamic banks, foreign exchange transactions (currencies from other countries) are permitted only to hedge against currency value fluctuations. The difference between the value of assets (what is owned) and liabilities (what must be paid) in foreign currencies when converted into local currency (rupiah), if it increases (revaluation), can be recognized as income or expense.

4. Islamic Investment Instruments

a. Sharia Stock

This type of stock is a financial instrument issued by the Islamic capital market. The key difference from conventional stocks lies in the nature of the business of the stocks. The issuing company must operate in accordance with Islamic law. Therefore, companies involved in alcohol, tobacco, and gambling cannot issue Islamic-compliant stocks. Additionally, these financial instruments

avoid practices such as *riba* (interest), *gharar* (excessive uncertainty), and *maysir* (gambling). The benefits of investing in Islamic-compliant stocks include:

- **Safe and Trustworthy Transactions:** Transactions are monitored by the Islamic Supervisory Board (DPS), the Indonesia Stock Exchange (IDX), and the Financial Services Authority (OJK).
- **Guaranteed Halal Profits:** Profits are ensured to be halal as the issuing companies do not produce prohibited (haram) products.
- **Business Activities in Compliance with Shariah:** Business operations are conducted in accordance with Islamic law to avoid *riba*, *gharar* (uncertainty), and *maysir* (gambling).

The market capitalization of the Indonesia Islamic Stock Index (ISSI) increased by 28.41% from 2022, with the value rising from IDR 4,786.02 trillion to IDR 6,145.96 trillion. Meanwhile, the number of stocks included in the Islamic Securities List (DES) reached 637. The market share of Islamic-compliant stocks has reached 67.41% of the total number of stocks (Otoritas Jasa Keuangan, 2024).

b. Sukuk

Sukuk is an Islamic-compliant investment instrument used for corporate financing. All processes involved, from issuance to trading, must adhere to Islamic economic principles. Consequently, *sukuk*, also known as Islamic bonds, must be free from elements of *riba* (interest), *gharar* (excessive uncertainty), and *maysir* (gambling). Other characteristics of Islamic-compliant bonds include:

- **Underlying Assets:** *Sukuk* must be backed by tangible assets such as services, land, or buildings.
- **Returns:** Returns can be in the form of profit-sharing ratios (*nisbah*), margins, or fees, depending on the type of contract.

According to the Financial Services Authority (OJK) report, the value of outstanding corporate *sukuk* through public offerings increased from IDR 42.50 trillion in 2022 to IDR 45.27 trillion in 2023. In terms of issuance, the cumulative value of corporate *sukuk* issuance rose from IDR 84.97 trillion in 2022 to IDR 99.86 trillion in 2023. Additionally, the value of outstanding government *sukuk* also saw an increase, reaching IDR 1,446.40 trillion by the end of 2023 (Otoritas Jasa Keuangan, 2024).

c. Islamic Mutual Funds

Islamic mutual funds are Islamic investment instruments where funds from investors are collected and then invested in money markets, stocks, and bonds in accordance with Islamic economic principles. The management of the investors'

funds is handled by investment managers. Therefore, investors simply enjoy the returns on their investments.

At the end of 2023, there were a total of 273 Islamic mutual funds with a total net asset value of IDR 42.78 trillion. By type, the Islamic mutual fund with the largest proportion in terms of net asset value is the Islamic mutual fund based on foreign securities, which accounts for 27.82%. This is followed by money market mutual funds at 16.90%, and Islamic equity mutual funds at 14.30% (Otoritas Jasa Keuangan, 2024).

5. Islamic Insurance Instruments

a. Takaful

Takaful is an insurance system based on Sharia principles and operates using a profit-sharing concept. Therefore, risks and profits arising are shared equally among all participants, including both financial institutions and policyholders. In the event of a claim, the costs are covered by the contributions paid by all participants. However, if there are no claims, the contribution funds can be managed for investment purposes. Like conventional insurance, Takaful also includes various types, such as life Takaful, health Takaful, and general Takaful, which cover various business risks.

In 2022, Islamic insurance assets increased by 3.93% compared to the previous year, rising from IDR 43,143.88 billion to IDR 44,840.39 billion. Islamic insurance assets are predominantly comprised of life Takaful, totalling IDR 34,948.70 billion, or 77.94% of the total insurance assets. (Otoritas Jasa Keuangan, 2023b).

6. Social Finance Instruments

a. Zakat

Zakat is an obligation that every Muslim must fulfill if they possess wealth exceeding a certain minimum amount. Zakat consists of two main types: zakat on wealth (*zakat maal*) and zakat fitrah. The purpose of zakat is to reduce social and economic inequality, assist those in need, and purify one's wealth.

Zakat is distributed to eight categories mentioned in the Quran, such as the poor, zakat collectors (*amil zakat*), recent converts to Islam, those in debt, and others. The management of zakat is carried out by official zakat institutions or trusted charitable organizations. This ensures that zakat is distributed to deserving recipients in an efficient and effective manner.

According to the National Zakat Agency (BAZNAS) report, zakat collection is divided into *zakat maal* and zakat fitrah. In 2022, the total collection of *zakat*

maal reached IDR 3.776 trillion, while the total collection of zakat fitrah amounted to IDR 204 billion (BAZNAS, 2022).

b. *Infak*

Infak is the voluntary act of giving money or assistance. Unlike zakat, *infak* does not have specific limits on amount or timing. You can give *infak* at any time and to anyone in need. The purpose of *infak* is to strengthen mutual help and solidarity among individuals. *Infak* can be used to support others in various ways, such as for education, health, or to build something beneficial.

Infak can be given directly to individuals in need or through organizations that assist those in need. There are no specific restrictions on who can receive *infak*, which distinguishes it from zakat, which has designated recipients.

According to the National Zakat Agency (BAZNAS) report, the total collection of *infak* and charity in 2022 reached IDR 2.363 trillion. Additionally, funds for other religious social activities (DSKL) amounted to IDR 538 billion (BAZNAS, 2022).

c. *Sadaqah*

Sadaqah is a voluntary donation given by a Muslim. This donation can be in the form of money, food, clothing, or even time, effort, and advice provided to others. Importantly, *sadaqah* is not limited to helping those in financial need but also includes any act of kindness. The purpose of giving *sadaqah* is to strengthen social bonds, draw closer to Allah, and bring blessings into one's life (Prudential Syariah, n.d.).

7. Other Islamic financial instruments

a. *Wakalah*

Wakalah is an agreement in which a person grants authority to another party, such as a bank, to perform tasks on their behalf. For example, an individual might authorize a bank to transfer money, collect debt payments, either through clearing or collection, or to execute a Letter of Credit (L/C). With this *wakalah* agreement, a person can entrust these tasks to another party with the expertise and experience to carry them out, ensuring that the management of these tasks is carried out effectively and efficiently.

b. *Kafalah*

The term "*kafalah*" refers to guarantee, burden, and responsibility. According to Sayyid Sabiq, *kafalah* is the process of transferring the responsibility of the guarantor (*kafil*) to the principal debtor (*ashil*) in a claim involving matters such as debt, goods, or work. In other words, *kafalah* is an agreement where the

guarantor provides a loan to the recipient of the guarantee, and the recipient is responsible for fulfilling the obligation owed to the guarantor.

c. *Hiwalah*

Hiwalah refers to the transfer or assignment of rights and obligations. This can occur through the shifting of responsibilities from one party to another. For example, it involves transferring a debt or receivable to another person. *Hiwalah* can also mean the transfer of funds from one person to another, or from one party to another (Winarno & Banu, 2016).

Development of Islamic Financial Instruments

The development of Islamic financial institutions has been progressing over time, and the concept of Islamic finance has been widely accepted globally, particularly in the Middle Eastern and Southeast Asian countries with large Muslim populations. As the Islamic financial system continues to grow, tools to support this progress are necessary, and Islamic financial contracts/instruments require innovation to address the evolving times and the needs of Muslims in the global financial market. The following are the developments in existing Islamic financial instruments, particularly in Indonesia, including:

1. Green Sukuk

Green sukuk is an advancement of sukuk (Islamic bonds) aimed at financing environmentally friendly projects such as energy efficiency, renewable energy, green buildings, green tourism, disaster risk reduction, sustainable transportation, waste management, natural resource management, and sustainable agriculture. The mechanism of green sukuk involves the issuance of sukuk by entities seeking to finance environmentally friendly projects. The issuer of green sukuk issues Islamic bonds, which are invested in by sukuk buyers, with the collected funds used specifically for projects that meet sustainability criteria, such as renewable energy or energy efficiency. The issuer then pays returns to investors according to the Islamic agreement. Additionally, the issuer is required to transparently report the environmental impact of the financed projects to ensure that the funds are used effectively and in line with the promised sustainability goals. Green sukuk emerges as an Islamic financial instrument where 100% of its use is exclusively dedicated to financing green projects that contribute to climate change mitigation and adaptation, as well as biodiversity conservation.

In March 2018, Indonesia issued a global green sukuk valued at USD 1.25 billion. The market response was very positive, indicating investor interest in

expanding their portfolios. Although the government has not set a value for green sukuk issuance for 2019, this instrument remains an alternative financing option for the country. Indonesia became the first country to issue green sukuk, following previous issuances of green bonds by countries such as France, Fiji, and Poland (Anggraini, 2018).

2. Waqf Based Sukuk

Sukuk issued in connection with waqf are based on waqf funds, whether for a fixed term or in perpetuity. Generally, these instruments can be divided into two categories: Sukuk-linked Waqf and Waqf-linked Sukuk.

Sukuk-linked Waqf is a type of purely commercial investment transaction where sukuk is issued by a company or business entity. The funds raised from this sukuk are used to develop commercial assets on waqf land or in connection with waqf projects. Examples of Sukuk-linked Waqf include the Zam-Zam Tower in Mecca and Al Warees in the Ben Coolen complex in Singapore.

In summary, the process of Sukuk-linked Waqf works as follows: The contractor/developer/investor enters a contract with a *nazhir* (waqf administrator) to develop property on waqf land for a specific period. The contractor/developer then issues sukuk, which can be purchased by the public as an investment. Although these sukuk have commercial characteristics, their religious value remains because the assets built on waqf land will eventually return to the *nazhir* for the benefit of eligible beneficiaries. The funds collected from the sukuk sale are used to build commercial properties. The contractor/developer/investor earns income from managing these properties. A portion of this income is used to pay rent to the *nazhir*, while the remaining income is used to repay the principal and margin of the issued sukuk. Once the sukuk is fully repaid and the contract period ends, the property is entirely managed by the *nazhir* (Saptono, 2018).

3. Islamic Fintech

Islamic fintech, as a form of Islamic financial instrument, represents an advancement from traditional financial transactions, aimed at making it easier for people to access information and funding through Islamic financial institutions. Fatwa No. 117/DSN-MUI/II/2018 issued by the National Sharia Council of the Indonesian Ulema Council (DSN-MUI) outlines information technology-based financing services that adhere to Sharia principles. These services utilize electronic systems and the internet to connect lenders with borrowers. Among the

derivative instruments of Islamic fintech are crowdfunding and Islamic-compliant P2P Lending (Trimulato, 2022).

Crowdfunding is a method of raising funds collectively from many people through online platforms. For example, if someone wants to start a new business but lacks sufficient funds, they can use crowdfunding to seek contributions from multiple people willing to contribute according to their capacity. An example of a successful crowdfunding platform is KitaBisa.

On the other hand, Islamic-compliant P2P Lending is a form of lending where individuals or businesses can borrow money from others through an online platform based on Sharia principles. In Islamic-compliant P2P Lending, the funds loaned, and the capital raised come from lenders who also share in the profits or risks with the borrowers.

Challenges and Opportunities in the Development of Islamic Financial Instruments

The development of Islamic financial instruments faces several challenges, including:

1. Regulation and Policy

Many countries lack uniform and comprehensive regulations for Islamic finance, which often do not align with conventional banking regulations. This creates uncertainty and barriers in the development of new instruments. Additionally, the absence of internationally agreed-upon standards for Islamic financial instruments, such as those issued by AAOIFI, complicates implementation and may lead to varying interpretations of Sharia principles.

A suggested solution to this regulatory and policy issue is the establishment of an international body specifically dedicated to issuing regulations and policies, ensuring that the implementation of Islamic principles is not complicated and carries significant authority.

2. Liquidity and Market Diversification

The market for Islamic financial instruments is often less liquid compared to conventional instruments, which hampers access and flexibility for investors. Moreover, the availability of Islamic financial instruments remains limited, restricting investor options and making it challenging to construct a diversified portfolio. There is a need for the development of more liquid Islamic financial instruments to reach a broader market.

3. Education and Knowledge

Many market participants, including investors and financial managers, lack understanding of Sharia principles and how these instruments operate. This hinders the adoption and growth of Sharia-compliant instruments. Additionally, the limited number of experts who understand Islamic finance principles and their application in the modern market presents a significant challenge. Therefore, massive outreach is needed to ensure the growth of these Islamic instruments is not limited to certain groups only, considering that the Islamic financial literacy index in 2022 was only at 9.14% (Otoritas Jasa Keuangan, 2022).

4. Product Complexity

Islamic financial instruments are often more complex because they must adhere to Sharia principles such as the prohibition of *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling). This complexity can make these instruments harder to understand and manage. Ensuring ongoing Sharia compliance also requires continuous oversight, increasing operational and administrative costs.

5. Technology Integration

The adoption of financial technology (fintech) in Islamic finance is still lagging, and the implementation of new technologies is often slow in this sector. This impedes efficiency and innovation in product development. With the increasing use of technology, data security becomes a significant issue in maintaining investor trust in Islamic financial products.

The rapid development of technology needs to be matched by the issuance of new Islamic financial instruments that are integrated with technology. Financial instruments that are easy to understand yet integrated with technology will facilitate access for the public, especially the younger generation who are already more tech-savvy.

6. Performance and Returns

Islamic financial instruments need to offer competitive performance and returns compared to conventional instruments to attract investor interest. This challenge is exacerbated by restrictions on the use of derivative instruments commonly employed in conventional markets. Managing risks in accordance with Sharia principles is often more challenging due to the limitations in using widely accepted risk management tools in the conventional sector (Handayani, 2015).

It is hoped that Islamic financial instruments can excel in terms of performance and returns, allowing them to reach a broader market and attract non-Muslim consumers, making them not exclusively for Muslims only.

Conclusion

Islamic financial instruments have shown positive growth each year. Various Islamic financial instruments are commonly used in the finance industry. For funding, instruments like *mudharabah*, *murabahah*, and *musyarakah* are often employed. There are also Islamic Financing Instruments that typically use *Ijarah Muntahiyah bit Tamlik* contracts. For savings and deposits, *wadiah* or *mudharabah* savings are commonly used, and there are Islamic investment instruments such as *sukuk* or *sharia* mutual funds. Islamic insurance is provided through *takaful*, and social instruments include *zakat*, *infak*, and *sedekah*.

Islamic financial instruments continue to evolve, with developments like *green sukuk*, *waqf-based sukuk*, and *sharia fintech* emerging. However, despite these annual advancements, there are challenges that Islamic financial institutions must address to reach a broader market. These challenges include international regulatory and policy alignment, liquidity and market diversification issues, the need for education on Islamic finance, product complexity, technological integration, as well as performance and returns.

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