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DOES FINANCIAL INCLUSION INTERACT WITH ISLAMIC BANKING INDUSTRY? EVIDENCE FROM SAUDI ARABIA

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ABSTRACT

The study aimed to explore interplay between financial inclusion and Islamic banking in Saudi Arabia. There were dimensions of financial inclusion matter to three challenges of Islamic banking such as trust, product development and competition. The empirical methodology was based on questionnaire distributed to adult male and female Saudi respondents. The respondents were male and female Saudi officers and customers of Islamic financial institutions. The questionnaire was distributed to the respondents through direct contact or online used Google. The endogenous variables included trust (TRUST), Islamic financial products development (PRODEV) and competitive posture (COMPOST). Meanwhile two indicators of financial inclusion included usage (USAGE) and quality (QUALITY). The statistical tools included correlation, partial correlation analysis, principal constructs analysis and regression analysis. The result showed there was limited impact of financial inclusion on Islamic banking in Saudi Arabia. However, most striking fact was clear dependence between quality impact of three aspects of Islamic banking. This result indicated that Saudi Islamic banks had improved product and services quality as Islamic banks offered their clients would trust more. Islamic banks will be endowed with higher product development ability and can strengthen their competitive power.

INTRODUCTION

Recent empirical studies, policy reports and government and supra-governmental initiatives published interesting facts about financial inclusion and its far-reaching impacts not only on short-term value creation but also on the long-term well-being in developing and emerging economies. The G20

report on financial inclusion emphasizes that the three dimensions of financial inclusion such as access, usage and quality which face some regulatory obstacles to be enforced in the practice.

The financial performance of bank is influence by overheads, liquidity, leverage ratios, earning, concentration, credit risk, solvency risk, deposits, GDP, inflation, interest rate and exchange rate [1]. Islamic banking is fast growing industry. In global, Islamic finance industry has been reported with 16% of compound annual growth rate from 2010 and 2014 and its asset are estimated to USD 1.87 trillion in 2014 [2]. Islamic financial industry growth was growth during financial crisis which the industry assets had grown of 19% and 21% respectively in 2011 and 2012 compared to conventional banks around the world [3].

The fundamental principle of Islamic finance such as risk and profit-sharing feature transaction, prohibition of interest (riba), gambling (maysir) and excessive uncertainty (gharar) [4] Islamic bank and conventional banks are differentiated commonly on the basis of their riba, risk sharing practices and their goal [5]. Islamic bank is known as any company that operates Islamic banking business and holds a valid licence [6]. Islamic banking system involves the products that did not include riba (interest) and follow Shari'ah principles which known as interest-free banking [7].

Islamic finance offers alternatives to conventional financial market instruments for who have religious sensitives or concerns [8]. The differences between Islamic banking and conventional banking are present of Shariah Supervisory Board (SSB) while conventional banking only have Board of Directors (BOD) in internal governance structure [9].

In previous study, Islamic banks were found more profitable, better capitalized, more liquid and lower credit risk than conventional banks [10]. In this study, the aim to explore interplay between financial inclusion and Islamic banking in Saudi Arabia.

METHODOLOGY

The empirical methodology was based on questionnaire distributed to adult male and female Saudi respondents. The questionnaire was designed to reflected four main parts included demographic information, financial inclusion, trust, Islamic financial products development, competitive posture. The study was focused on Saudi economy. Policy implication was inferred from study findings to generalize into GCC countries. The respondents were male and female Saudi officers and customers of Islamic financial institutions. The questionnaire was distributed to the respondents through direct contact or online used Google. The endogenous variables included trust (TRUST), Islamic financial products development (PRODEV) and competitive posture (COMPOST). Meanwhile two indicators of financial inclusion included usage (USAGE) and quality (QUALITY). The statistical tools included correlation, partial correlation analysis, principal constructs analysis and regression analysis.

In this study, first hypothesis as interaction between financial inclusion and Islamic banking improved the individuals and businesses' trust in Islamic banks. The financial innovative ability of Islamic financial institutions turned out to be weak. In effect, several specialists and academic contributors believed that the offered Islamic financial products and services did not meet the needs of their customers. The corporations wishing to use shariah-compliant instruments were not satisfied with the specificities of such instruments and did not see their risks managed with reliable, sophisticated risk-hedging instruments. Meanwhile, second hypothesis was process of financial inclusion contributed to the development of new, sophisticated Islamic financial products and services that met the customer needs. A supplementary dimension related to the strategic posture can be studied in the light of the interplay between Islamic finance and financial inclusion. As a matter of fact, Islamic financial institutions aim at enhancing their competitive power in order to better their competitive posture in the industry. Third hypothesis was process of financial inclusion contributed to the enhancement of the Islamic Banks' competitive posture.

RESULT AND DISCUSSION

Principal Components Analysis

Table 1 showed the principal component analysis. The goal was used the respondent answer to determine the relevant constructs which leads to regression analysis. The purpose to use the information provided by data to reduce the number of variables through rotation and extraction. In Table 1, loadings of all questions were higher than 0.5 which was acceptable and indicative that high percentages of the information were kept by the questions after extraction. Furthermore, Questions 12 and 10 were positively and highly correlated with construct 1 while Questions 6 and 8 were positively and highly correlated with construct 2. Construct 1 was better interpreted to reflect quality and construct 2 was better interpreted to reflect usage.

Table 1. Financial Inclusion: Loadings and Matrix of Constructs with Varimax

| Questionnaire | Loadings | Construct | |
|---|----------|------------|----------|
| | | 1: Quality | 2: Usage |
| Q12, Do you consider that you and the clients of your bank are better off when using the offered products and services? | 0.646 | 0.815 | 0.077 |
| Q10, Do you consider that the staff helps you to have an easy access to the bank's products and services? | 0.733 | 0.803 | 0.030 |
| Q8 For how long you are using the services of your bank? | 0.646 | -0.121 | 0.847 |
| Q6, Do you think that your bank was able to increase its number of accounts? | 0.671 | 0.267 | 0.758 |

In Table 2, two constructs included access and quality. The access construct was reflected by Question 4, 5 and 6 since these questions had highly and positive correlated with construct 1. In addition, Question 1,2 and 3 had highly and positive correlated with construct 2.

Table 2. Trust: Loadings and Matrix of Constructs with Varimax Rotation

| Questionnaire | Loadings | Construct | |
|--|----------|-----------|------------|
| | | 1: Access | 2: Quality |
| Q1 , do you consider that your bank updates the offered products and services? | 0.549 | -0.091 | 0.749 |
| Q2 You can rely on the efforts of your bank to satisfy your needs. | 0.573 | 0.061 | 0.754 |
| Q3 , you trust that the products and services provided by this bank have an optimal quality-to-price ratio. | 0.663 | 0,534 | 0.615 |
| Q4 The bank shows a high interest to serve its customers. | 0.691 | 0.821 | 0.131 |
| Q5 Your relationship with staff of the bank is very close. | 0.557 | 0.737 | -0.119 |
| Q6 The trust in the bank increases the number of customers | 0.214 | 0.460 | 0.051 |

In Table 3, the product development had two items that reflected quality such as Quality1 and Quality2. Quality 1 was reflected by question 2 and 9 and Quality2 was reflected with question 4 and 8. Each of two items reflected to the sophistication used during new product development. However, Quality2 was related to the willingness and efforts to develop new financial products.

Table 3. Product Development: Loadings and Matrix of Constructs with Varimax Rotation

| Questionnaire | Loadings | Construct | | | |
|--|----------|-----------|-----------|-------------|-------------|
| | | 1: Usage | 2: Access | 3: Quality1 | 4: Quality2 |
| Q1 Your bank's offered products and services are sophisticated | 0.604 | 0.822 | -0.086 | 0.195 | 0.002 |
| Q2 Your bank is using Islamic principles from Quran and Sunnah to develop and enhance the offered products and services | 0.677 | -0.767 | -0.062 | 0.106 | -0.032 |
| Q3 There is a suspicion in the use of | 0.758 | 0.144 | 0.771 | 0.094 | 0.232 |

| | | | | | |
|--|-------|--------|--------|--------|--------|
| prohibited interest in any of your bank's offered products and services | | | | | |
| Q4 The products and services offered by your bank cannot be developed | 0.647 | 0.221 | -0.705 | 0.187 | 0.265 |
| Q5 Your bank must develop new products and services | 0.626 | -0.027 | 0.227 | -0.756 | -0.112 |
| Q8 Your bank is doing enough efforts to develop new products and services that satisfy your needs | 0.636 | 0.097 | 0.407 | -0.118 | 0.676 |
| Q9 You believe that your bank was able to attract new customers because its products and services are sophisticated | 0.651 | -0.091 | -0.068 | 0.847 | 0.167 |
| Q10 You continuously use the products and services of your bank because you think they are sophisticated | 0.722 | 0.621 | 0.131 | -0.416 | 0.225 |

In Table 4, loadings for all questions were higher than 0,5 which was acceptable. Question 1 and 2 were positively and highly correlate with construct 1 while Question 2, 3 and 4 were positively and highly correlated with construct 2.

Table 4. Competitive Posture; Loadings and Matrix of Constructs with Varimax Rotation

| Questionnaire | Loadings | Construct | |
|---|----------|-----------|----------|
| | | 1: Access | 2: Usage |
| Q1 Is your bank the main bank in the Saudi banking industry? | 0.543 | 0.790 | -0.041 |
| Q2 The features of the products and services of your bank are the most important to increase its market share. | 0.626 | 0.733 | 0.072 |
| Q3 Your bank can attract new customers because of the low costs as compared to its competitors. | 0.688 | -0.222 | 0.799 |
| Q4 Using the products and services of your bank over a long period can | 0.579 | -0.293 | 0.702 |

| | | | |
|-----------------------|--|--|--|
| attract new customers | | | |
|-----------------------|--|--|--|

Table 5 summarized the constructs and the corresponding questions that represented the items. KMO and Bartlett tests indicated the degree of suitability of the collected data for structure detection. Bartlett was statistically significant (p-value = -0.004), which meant that the data were suitable for factor analysis. In addition, KMO test showed that the return value was higher than 0.5.

Table 5. Construct Analysis

| | | Questions* | Kaiser-Meyer-Olkin** | Bartlett*** |
|---------------------|--|---------------------------|----------------------|-------------|
| Financial inclusion | Finincl_Quality Finincl_Usage | 10&12 6&8 | 0.535 (19.127) | (0.004) |
| Trust | Trust_Acess Trust_Quality | 4,5 &6 1,2 &3 | 0.543 (56.502) | (0.000) |
| Product development | Prodev_usage Prodev_quality1 Prodev_quality2 Prodev_process | 1&10 2&9 8&4 3&5 | 0.478 (34.032) | (0.200) |
| Competitive posture | Compost_access Compost_usage | 1&2 3&4 | 0.507 (7.279) | (0.296) |

*The questions were related to the corresponding part in the questionnaire.

** The reported value in parenthesis corresponds to Khi-squared statistic.

*** The reported value in parenthesis was the statistics that corresponds to Bartlett test

Bivariate Analysis

All correlation between Finincl_usage and trust or competitive posture were either negative or positive and very low but all correlation coefficients were not statistically significant. All correlations between Finincl_usage and all items of product development were either negative or positive but could not statistically accepted as correlated. This result meant that Saudi customers consider that usage as a main aspect of financial inclusion was not related to product development. In other terms, usage was not a main motive for Saudi banks to develop new Islamic financial products and services.

All correlations between Finincl_Quality and all items of product development are positive, except Prodev_usage. However, there is a single Pearson correlation that is positive and statistically significant. This means that Saudi customers believe that the product development is closely related to the quality of offered products and services. In other words, Saudi customers

believed that Saudi banks developed new products because offered the quality of their array of products and unnecessarily for the purpose of increasing the usage of their customers over the long term. This result seems to reflect a particular interpretation by Saudi customers in a way that they believe that Saudi banks were willing to continuously improve the quality of their products, which indirectly increase the usage of their services. As a consequence, an order of priority in the process of incorporating the impact of financial inclusion on Saudi Islamic banking. Quality matters more than usage. There were three positive and statistically significant correlation coefficients between the first construct of financial inclusion, namely quality such as *Finincl_quality* and three items of Islamic banking, each belongs to a different construct. The highest correlation coefficient is between *Finincl_quality* and *Trust_quality*. This finding meant that Saudi customers considered that the quality of products that are supposed to satisfy their needs is positively associated with their trust in the bank. The second highest correlation coefficient is between *Finincl_quality* and *Compost_access*. This finding implied that when Saudi banks make efforts to enhance the quality of their products and services to meet the needs of their individual and business clients, their competitive posture tends to increase and be strengthened.

Table 6. Pearson Correlation*

| Islamic banking | Financial inclusion | |
|------------------------|------------------------|----------------------|
| | <i>Finincl_quality</i> | <i>Finincl_usage</i> |
| Trust | | |
| <i>Trust_access</i> | -0.148 (0.222) | 0.009 (0.943) |
| <i>Trust_quality</i> | 0.352 (0.003) | -0.042 (0.733) |
| Pro development | | |
| <i>Prodev_usage</i> | -0.090 (0.470) | 0.056 (0.657) |
| <i>Prodev_quality1</i> | 0.060 (0.632) | -0.002 (0.990) |
| <i>Prodev_quality2</i> | 0.171 (0.169) | 0.081 (0.520) |
| <i>Prodev_access</i> | 0.205 (0.099) | -0.126 (0.315) |
| Comp Posture | | |
| <i>Compost_access</i> | 0.338 (0.004) | -0.145 (0.231) |
| <i>Compost_usage</i> | -0.020 (0.871) | -0.048 (0.693) |

In Table 7, the results showed two main findings. The usage dimension of financial inclusion did not matter to the three aspects of Islamic banking. On the other hand, the quality dimension of financial inclusion matters to some extent to the three aspects of Islamic banking. This means that Saudi respondents in the sample believe that Saudi banks considered the quality dimension preached by financial inclusion to improve the trust of their customers, to innovate new products according to *fiqh* rules, and improve their competitive power. Moreover, the results did not show that Saudi banks did the same by taking into account of the usage dimension of financial inclusion. A central recommendation was the urgent need to focus on the usage dimension (in terms of regularity and duration) to improve the three aspects of Islamic banking.

Table 7. Regression Results

| | Regressors | p-value | |
|---------------------|-----------------|-------------------|-------------------|
| | | FinInclu_quality | FinInclu_usage |
| Trust | Trust_access | -0.147 (0.226) | 0.008 (0.948) |
| | Trust_quality | (0.350 (0.003) | -0.40 (0.749) |
| Product development | Prodev_usage | -0.091 (0.469) | 0.056 (0.652) |
| | Prodev_quality1 | 0.060 (0.634) | -0.002 (0.985) |
| | Prodev_quality2 | 0.170 (0.174) | 0.077 (0.529) |
| | Prodev_access | 0.206 (0.096) | -0.126 (0.298) |
| Competitive posture | Compost_access | 0.335 (0.004) | -0.146 (0.211) |
| | Compost_usage | -0.020 (0.871) | -0.049 (0.695) |

Overall regression results showed that there was a limited impact of financial inclusion on the three aspects of Islamic banking, which corroborates the bivariate and partial correlation analyses. Indeed, at least one item corresponding to each of the three Islamic banking aspects is positive and statistically significant. This is striking for the aspect related to product development because only one item is positive and significant. An additional result was clearly shown through the weak relevance of the usage dimension and the relevance of the quality dimension of financial inclusion to the Islamic banking industry. These results confirm totally previous findings because the quality dimension of financial inclusion seems to be the most informative about how the latter can have interplay with Islamic banking. The results indicated that Saudi customers consider that if banks focused on the various aspects of the quality of the products and services they offer, this will impact positively the whole industry of Islamic banking, as viewed from its three aforementioned aspects.

CONCLUSION

In conclusion, the finding found Saudi Islamic banks had improved product and services quality as Islamic banks offered their clients would trust more. Islamic banks will be endowed with higher product development ability and can strengthen their competitive power.

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