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## INVESTIGATING THE ROLE OF FINANCIAL INNOVATION ON ISLAMIC FINANCIAL INSTITUTIONS PERFORMANCE DURING COVID-19

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KEYWORDS	ABSTRACT
Financial Innovation, Financial Technology, Digitization, Covid-19, Performance	<p>During the present COVID-19 pandemic, this study explain the critical role of Financial Innovation (FI) in stabilizing the Islamic financial institutions in term of digitization, financial inclusion and financial technology. The simple random sampling was used to collect data from the managerial staff of IFIs from selected part of Pakistan. Questioner was used to collect data from 316 survey respondents. The researchers analysed data using Smart-PLS SEM software. For data analysis, the variety of statistical approaches were used, including descriptive statistics, reliability analysis, correlation analysis, and structural equation modelling. Results provide significant information in terms of the digitalization, financial technology, and financial inclusion, Islamic financial institutions have substantial impact on financial innovation. This research is limited to Islamic financial institutions in Pakistan. The future research may look into other instiutions across the country to examine the impact of financial innovation by comparing the Islamic and conventional financial sectors.</p>  <p>2022 Gomal University Journal of Research</p>
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### INTRODUCTION

Financial innovation (FI) is necessary to ensure stability of Islamic financial institutions during COVID-19 outbreak. The recent COVID-19 epidemic has caused havoc on every facet of human life, prompting a global race among experts and governments to devise the realistic strategy for mitigating the harm (Ahmad, Sohail & Nawaz, 2021). Despite pandemic impact on all economic sectors, global financial industry sustained most severe harm, culminating in an unsustainable burden as a result of the sector's direct and indirect influence on the human activities on a daily basis. Following the epidemic, measures like as social isolation, lockdown and quarantine were started, effectively shutting down economy (Torre, Liuzzi & Marsiglio, 2021). Economic closures have repercussions throughout range of businesses, including tourism, manufacturing, sports

and leisure, and banking. There is a significant likelihood that banking sector will be worst hit, given it is where majority of people manage their money (Banna & Alam, 2020). The economic well-being of country is liable on stability of its banking sector. Banking sector (conventional & sharia) must maintain stability in order to assure global financial sustainability in an orderly manner (Khraisha & Arthur, 2018). For time being, experts are focusing their efforts on Islamic banks because to their shown stability and durability during the 2007–2009 Global Financial Crisis, which wreaked havoc on economies worldwide, most notably banking industry (Ahmed, 2010).

Additionally, the Islamic banks provided financial services to people who had previously been excluded from the banking system because to their religious hostility to conventional banking institutions (Naceur & Roulet, 2017). As a result, Islamic banking is a preferred option for these people since it adheres to Islamic financial regulations and provides them with salvation both now and in the future. Given the crucial role Islamic banks play in human wellbeing, it is only logical to emphasise their stability and growth (Ahmad, Sohail & Nawaz, 2021). As a result, the appropriate implementation of FI should be extensively evaluated to maintain Islamic banking stability. With use of advanced technology and established financial institutions, FI makes it possible for anybody with internet-connected electronic device (such as a smartphone, laptop, iPad or tablet) to access the financial services from anywhere (Ozili, 2018). In this connection, banking may be bound to depend on FI to maintain its financial operations in face of epidemic physical limits. It's also an opportunity for the banking industry to completely integrate digital financial services, as other institutions across globe have already done in response to epidemic (Ellis, 2020). In this connection, multiple conventional financial institutions have been using digital banking services for revenue generation and optimization, which has had the favorable impact.

In response, the Islamic banking industry has strengthened its Financial Institutions (FI) and put to good use its post-Global Financial Crisis (GFC) expertise (Ahmed et al., 2015). COVID-19 is likely to put Islamic banking on a more stable footing if FI is properly implemented. Despite fact that FI is crucial to Islamic financial institutions, relatively little empirical study has been done on the influence of FI on bank stability. Despite the fact that Banna (2020) concluded that FI benefited banking stability. Due to the high amount of financial innovation, FI may have a negative impact on financial stability. No one knows whether appropriate implementation of FI would improve Islamic financial institution sector stability in case of the COVID-19 pandemic due to its positive and negative qualities. This study evaluates use of FI in light of the outbreak. This study is significant for Islamic financial institutions to implement latest digital technology in order to get competitive advantage. FI brings together cutting-edge technology with proven financial institutions to simplify the Islamic financial institutions process by enabling remote access to financial services through an electronic device (such as a mobile phone, a laptop, an iPad or tablet) with internet connection (Ozili, 2018). As consequence, proper implementation of FI in the Islamic banking sector is expected to maintain its stability in the face of the COVID -19.

## LITERATURE REVIEW

The terms innovation and "national development," as well as "technological advancement" and "economic success," are often used interchangeably. Innovation has become a vital component of any organization's success in today's competitive business environment (Alamad, 2017). The

literature has emphasised critical significance of innovation in achieving a lasting competitive edge in today corporate climate. According to several authors, innovation is typical instrument that financial organisations might use to secure competitive advantage in economic operations (Samsudin, 2016). Poon, Chow, Ewers and Ramli (2020) defines the innovation in the financial services delivery system as 'a chance to obtain a competitive advantage' that would offer a retail banking service provider with 'foundation for difference'. Similarly, Ali and Puah (2017) assert that innovation is critical for establishing a sustained competitive edge in today's environment. Fintech technology may be used to Islamic finance, which is based on Shari'ah rules. As result, recent research, Walimbe (2021) have examined computational challenges of Fintech-based solutions for the Islamic financial business (Todorof, 2018). Thus, Fintech's Shari'ah-compliant character is a contentious issue, yet the Islamic banking sector can't deny the several uses of Fintech. According to Elasrag (2019), the Shari'ah-compliant goods and services in the Islamic finance business may be ensured via implementation of smart contracts (Jamil & Abu Seman, 2019).

As a result, research into use of Fintech in Islamic banking industry has accelerated in recent years (Abojeib & Habib, 2019). As a consequence of these considerations, Islamic banking has risen to become world biggest banking industry and continues to improve in all of its activities by generating profits to provide vital stability (Imam & Kpodar, 2013). As a result, the Islamic banking has shown resilience in face of financial crises, as seen by its ongoing presence during the GFC (Maherhasan & Jemmadriddi, 2012). Additionally, Islamic banking industry was noted to be robust as a result of its survival throughout the crisis via introduction of novel products such as FI (Banna et al., 2020). Even individuals who are poor or reside in remote regions may benefit from financial success and security. FI in financial industry has been proved to increase financial stability and growth which aids poor by reducing poverty. When it comes to financial institutions, Fintech refers to a new technology that removes requirement for physical presence (Manyika et al. 2016). As a result of this, electronic or remote access to the bank enhances both efficiency and stability of institution. The formalization of informal companies via FI execution is critical to growth of a country's economy as whole. Unregistered businesses might be quickly taxed thanks to their presence in the database (Klapper et al., 2019). Islamic banks worldwide have started digitising their operations in anticipation of evident effect of FI (Knaack & Gruin, 2020).

There has been substantial amount of empirical research on influence of FI on banking stability, however findings are inconsistent. Only a few studies have looked at impact of FI on stability of conventional banks, but even fewer have looked at the impact on Islamic banks. Due in part to the fact that Islamic financial institutions are currently developing their FI, As a result of recent outbreak of COVID-19, this study focuses on Islamic banking's FI role in assuring its stability. By adopting financial innovation, Islamic financial institutions strengthen their technological skills, hence increasing the stability of the financial system. Financial success and stability may benefit anybody, even those who are impoverished or live in rural areas. It has been shown that the application of FI in the financial sector promotes FI growth and stability, which helps poor people by alleviating poverty (Siddik & Kabiraj, 2020). Few studies have examined the impact of FIs on Islamic financial institutions, despite the critical role in Islamic financial institutions overall success. However, Khraisha and Arthur (2018) observed that FI may have a detrimental effect on banking stability because of the high level of financial innovations. In light of both the advantages and disadvantages of FI, it has to be seen if its execution would improve Islamic

banking's stability in the face of a COVID-19 pandemic. Due to pandemic, the FI application's role in Islamic institutions success is critical. Financial innovation, as drawn in literature study, improves Islamic financial institutions' reputations with stakeholders and increases operational efficiency.

### METHODOLOGY

A cross-sectional survey was conducted using questionnaires to examine IFI’s opinions on the financial innovation which was measured through three proxy variables namely, the financial technology, digitization and financial inclusion. The population of study consist of managerial level employees working in Islamic Financial Institution operating in Pakistan. The researcher used probability technique to collect data as population of study was known. Rresearcher used simple random sampling for collecting of data from the managerial staff of IFIs selected part of Pakistan as such type of sampling technique was advised by the previous researchers for such types of studies (Singh & Singh, 2015). The researchers adopted questioner from past literature (Ahmad, Sohail, & Nawaz, 2021; Sohail & Nwaz, 2021). Questioner was used to collect data from 316 survey respondents. Administration of questionnaire on IF’s managers was conducted by researchers themselves, and with permission, they visited different branches of each IFI’s participating in the research. IFI’s managers volunteered to participate in survey. The returned questionnaires were carefully reviewed to ensure accuracy and completeness of information. The data was analysed using Smart-PLS SEM software. Structural equational modelling and reliability analysis and correlation were some of the statistical approaches used to analyse the data.

### RESULTS OF STUDY

The results are offered in this section and according to Table 1, majority of respondents are male and married between the ages of 26 and 30 years. Demographic data suggested that male is predominate in Islamic banking organisations. Similarly, bulk of responders had 4-6 years of job experience as evident from the frequencies tabulation concerning the demographic information in results.

**Table 1**  
*Demographic Profile*

		F	%
Gender	Male	233	73.7
	Female	83	26.3
Marital Status	Single	127	31.5
	Married	189	68.5
Age	Less than 25 year	60	19
	26-30 year	112	35
	31-40 year	84	26
	41-50 year	44	14
Working Experience	1-3 year	99	31
	4-6 year	139	44
	7-10 year	53	17
	Above	25	08

**Instrument Reliability & Validity**

The Cronbach's Alpha is used to examine the internal consistency and dependability of specified variables. There are high scores for both Alpha and AVE in the Cronbach alpha test, indicating that the variables/dimensions tested are suitable for further analysis in order to ensure internal consistencies.

**Table 2**

*Reliability & Validity Test*

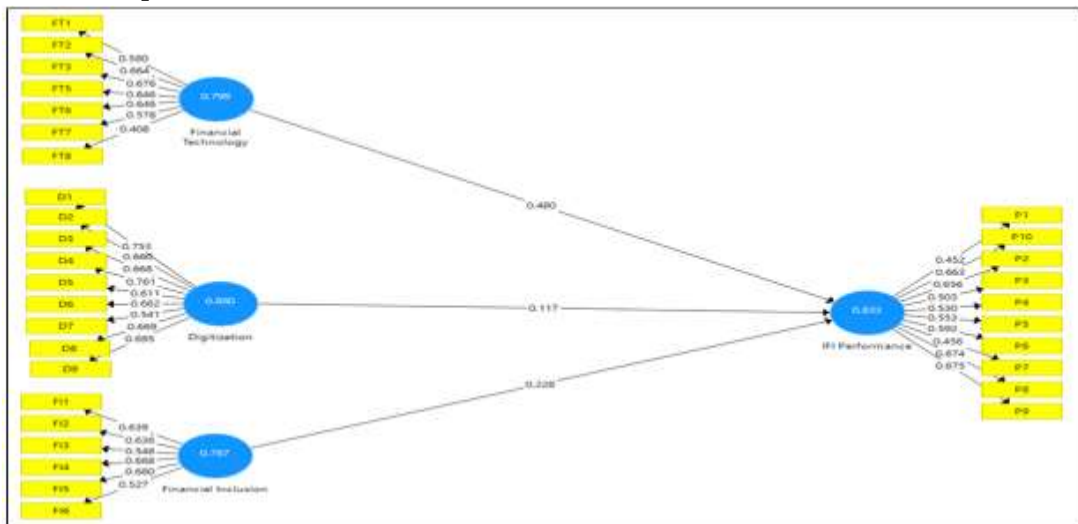
Variables Name	Loadings	C_Alpha	rho_A	CR	AVE
IFI Performance	Overall	0.776	0.785	0.883	0.535
	P1	0.452			
	P2	0.656			
	P3	0.503			
	P4	0.530			
	P5	0.553			
	P6	0.592			
	P7	0.456			
	P8	0.674			
	P9	0.675			
	P10	0.663			
Digitization	Overall	0.849	0.680	0.880	0.551
	D1	0.753			
	D2	0.660			
	D3	0.668			
	D4	0.761			
	D5	0.611			
	D6	0.662			
	D7	0.541			
	D8	0.669			
	D9	0.695			

**Table 2a**

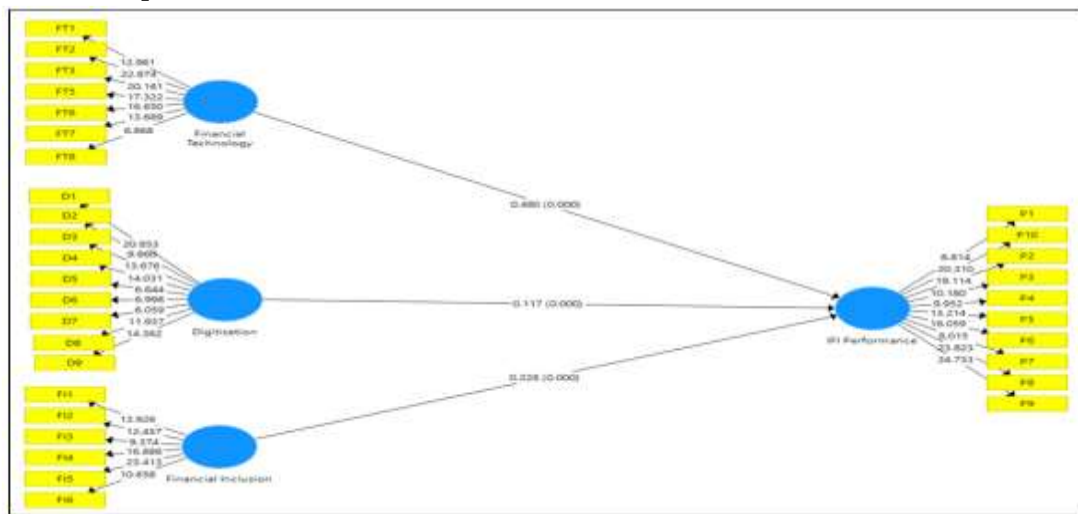
*Reliability & Validity Test*

Variables Name	Loadings	C_Alpha	rho_A	CR	AVE
Financial Inclusion	Overall	0.702	0.716	0.787	0.583
	FI1	0.639			
	FI2	0.636			
	FI3	0.548			
	FI4	0.668			
	FI5	0.680			
	FI6	0.527			
Financial Technology	Overall	0.706	0.781	0.799	0.567
	FT1	0.580			
	FT2	0.664			
	FT3	0.676			
	FT5	0.646			
	FT6	0.645			
	FT7	0.578			
	FT8	0.408			

**Figure 1**  
*Structural Equational Model*



**Figure 1a**  
*Structural Equational Model*



The structure equation model's output is shown in below figures and above table with diverse significant results that helps in deciding the relationships and reaching the desired conclusion. The results revealed that there is strong correlation between the success of the Islamic financial institutions over all factors included in analysis. Financial inclusion and financial technology and digitization have the positive impact on the performance of IFIs, according to the overall findings.

**Table 3**  
*Structural Equational Model*

	OS (O)	SM (M)	SD (STDEV)	TS ( O/STDEV )	P Values	Hypothesis
Digitization -----> IFI Performance	0.117	0.126	0.028	4.232	0.000	Supported
Financial Inclusion ---> IFI Performance	0.228	0.231	0.042	5.37	0.000	Supported
Financial Technology -----> IFI Performance	0.48	0.48	0.041	11.634	0.000	Supported

## DISCUSSION

Banks become more efficient as a result of financial innovation, delivering superior service to their customers while also saving them money. As a bank regulator, the State Bank of Pakistan constantly pushes Islamic banks to innovate in order to better serve their customers and also makes suggestions for effective adoption of digital Islamic banking. According to the literature, technological advancements (mobile & internet) combined with their worldwide adoption are altering consumers' expectations (Chuen & Teo, 2015). The financial resources and institutions have expanded fast as consequence of technological improvements. Examples include internet or mobile banking, online payment gateways for organisations such as paypro and installation of biometric and queuing matrices in banks. Customers may profit from financial technology by obtaining services quickly and reliably according to Bank Islamic which provides a number of financial technology based services including Cardless ATMs. The financial technology and product development must adhere to Sharia compliant standards." In terms of digitization, the Islamic finance sector will be no different from rest of the global financial industry. As a result of COVID 19, Islamic banks' capacity to handle crisis will be tested, but there is extraordinary opportunity for them to market their digital products and educate the public about the financial innovation.

According to an assessment of the literature, Pakistan has the low rate of financial inclusion in relation to the regional and global benchmarks (Baber, 2019). The respondents believe financial innovation is a prudent strategy for increasing credit availability, given the majority of services are already available through online channels. The FI in financial industry has been proved to increase financial stability and growth which aids poor by reducing poverty. When it comes to financial institutions, Fintech refers to a new technology that removes requirement for physical presence. As a result, the Islamic banking has shown resilience in face of the financial crises, as seen by its ongoing presence during the GFC. It facilitates day-to-day company operations and increases corporate sector efficiency by enabling the transactions to be completed immediately, which benefits consumers. Thus, prior to delivering the financial innovation, any product must be approved in accordance with Sharia. Numerous answers explore financial innovation and religion's role in maintaining Sharia conformance. Therefore, the Islamic banks rely entirely on Sharia-compliant boards. Additionally, the board consults with highly trained Sharia scholars. Riba has been eradicated entirely in the Islamic banking as the result of their efforts. A Sharia board should be contacted over new fintech advances to see if they are consistent with Sharia principles.

## CONCLUSION

This paper examines the important role of the financial innovation (FI) in stabilizing Islamic financial institutions during current COVID-19 outbreak. According to findings, Digitization, Financial Technology and financial inclusion as a proxy of financial innovation has significant effect on Islamic financial institution performance. The study will contribute to the body of knowledge on Islamic banking and financial institutions in a variety of ways. The goal of this research was to ascertain the role and importance of financial intermediation in guaranteeing Islamic banking's stability. Second, unlike earlier studies (Ahamed and Mallick, 2019; Van et al., 2020), this study focuses on critical components of financial innovation in Islamic financial institutions. Finally, this research should help accelerate the implementation of FI in Islamic financial institutions by assisting the governments in effectively implementing social distancing measures aimed to avert the emergence of COVID-19 and preserve the financial stability. This research focuses only on Islamic financial institutions mainly on Islamic banks in Pakistan. In the future, researchers may compare the Islamic and conventional financial sectors to examine the influence of financial innovation. Furthermore, the future researcher may use qualitative method e.g. interview or focus group to collect the data from respondents in order to get deep insights.

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