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Mitigation Strategies and Moral Hazard Risk Management in Sharia Financial Institution Financing Contracts

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Abstract: This study aims to analyze mitigation strategies and moral hazard risk management in Islamic financial institution financing, with a particular focus on mudharabah contracts. Moral hazard often arises from information asymmetry between banks as shahibul maal and customers as mudharib, creating opportunities for financial statement manipulation, fund misuse, and profit concealment. The research applies a qualitative method through library research by reviewing academic literature on Islamic financing contracts, risk, and control strategies. The findings reveal that risk mitigation is implemented through proactive measures, including screening, data verification, 5C and 6A analysis, and prudential principles, as well as reactive measures such as monitoring, supervision, and the application of sharia-based sanctions.

Keywords: Moral Hazard; Risk Mitigation; Islamic Financing; Mudharabah.

Abstrak: Penelitian ini bertujuan untuk menganalisis strategi mitigasi dan manajemen risiko moral hazard dalam pembiayaan lembaga keuangan syariah, dengan fokus pada akad mudharabah. Moral hazard sering muncul akibat asimetri informasi antara bank sebagai shahibul maal dan nasabah sebagai mudharib, yang memunculkan potensi manipulasi laporan keuangan, penyalahgunaan dana, hingga penyembunyian keuntungan. Penelitian menggunakan metode kualitatif melalui studi pustaka dengan menelaah literatur akademik terkait kontrak pembiayaan syariah, risiko, serta strategi pengendalian. Hasil penelitian menunjukkan bahwa strategi mitigasi dilakukan melalui pendekatan proaktif, seperti screening, verifikasi data, analisis 5C dan 6A, serta prinsip kehati-hatian, dan pendekatan reaktif berupa monitoring, supervisi, serta penerapan sanksi syariah.

Kata Kunci: Moral Hazard; Mitigasi Risiko; Pembiayaan Syariah; Mudharabah.

A. Introduction

Economic growth is a key indicator in assessing the level of community welfare and stability of a country. Inclusive growth can only be achieved if all levels of society have adequate access to financial services. Access to financial services not only promotes individual welfare, but also acts as a catalyst for strengthening the national economy (Haruna et al., 2024). However, in reality, most low-income Indonesians, such as small and medium enterprises (SMEs), still face various obstacles in accessing financial services, even though this sector is often the backbone of the economy (Rismanto, 2025).

Sharia financial institutions serve as alternative institutions that offer a more inclusive approach by upholding the principles of justice and conformity with the socio-cultural values of Indonesian society, which is predominantly Muslim (Margareta et al., 2025). Institutionally, Islamic financial institutions include various entities, such as Islamic Commercial Banks, Islamic Business Units, Islamic Rural Banks , and Islamic microfinance institutions such as Islamic cooperatives or Baitul Maal wat Tamwil (BMT). This diversity of institutional forms allows for the application of sharia principles such as the prohibition of usury, fairness in transactions, and risk sharing at the macro and micro levels, thereby reaching communities that are not yet served by conventional financial institutions (Alshater et al., 2022).

As an intermediary institution, Sharia Financial Institution have the main function of collecting funds from the public and channeling them back in the form of financing based on sharia principles. One of the contracts widely used in financing practices is mudharabah. According to the Financial Services Authority, mudharabah is an agreement between the capital owner (shahibul maal) and the business manager (mudharib) to carry out business activities in accordance with sharia principles, with a profit-sharing mechanism based on a ratio agreed upon from the outset. The importance of this contract is also reflected in the 2024 Sharia Banking Statistics data, which records that mudharabah-based financing reached IDR 16.3 trillion, a significant increase compared to 2023, which was recorded at IDR 12.25 trillion.

However, the effectiveness of mudharabah-based financing remains debatable. This is due to a number of factors, such as the managerial capabilities of customers, moral hazard risks, and challenges in the process of monitoring and assisting businesses (Rahardiansyah et al., 2023). In Islamic banking, moral hazard arises due to asymmetric information, which occurs when customers have full control to observe and manage their businesses, while banks as fund providers do not have adequate access to information (Yusuf et al., 2023). This situation often occurs in profit and loss sharing (PLS)-based financing such as mudharabah and musyarakah because there are no mandatory guarantees and full rights are given to business managers to operate their businesses, thus opening up opportunities for some customers to hide profits or exaggerate loss reports in order to reduce profit sharing obligations. Moral hazard can also be caused by internal factors within the institution. Internal factors are risks that arise from financial institutions that perform incorrect financing analysis, either due to carelessness in conducting the analysis or as a result of collusion between the financing analyst and the customer, which leads to deception in the analysis process and is carried out subjectively (Gurhanawan, 2020).

As a result, the level of Non-Performing Financing (NPF) in mudharabah contracts tends to increase and correlates positively with moral hazard. For Islamic banks, this encourages a more cautious attitude in disbursing financing, which in turn reduces the amount of financing, bank income, and profit sharing for fund owners (shahibul maal). For customers, moral hazard creates limitations in access to capital due to a lack of trust from banks. In the long term, this condition not only weakens the performance of institutions and customer businesses, but also has the potential to hamper economic growth because Islamic banks are not optimally functioning in their role of channeling funds.

B. Research Methods

This study uses a qualitative research method with a library research approach. This method was chosen because it is in line with the research objectives, which focus on conceptual and theoretical analysis of various relevant literature, including scientific articles, books, and other credible sources. Qualitative library research is conducted by reviewing and analyzing reading sources to gain a deeper understanding of the phenomenon being studied (Adlini et al., 2022).

Researchers used descriptive-analytical methods to analyze the collected data. The varieties of moral hazard in financing contracts, Islamic financial institutions' mitigation strategies, and the efficacy of risk management are the primary topics covered. Both recent research that highlight risk management procedures in modern Islamic financial institutions and the views of past academics on Sharia rules and contracts are covered in the texts used. Examining how mitigation techniques can be useful instruments for managing moral risk is the aim of this investigation. Furthermore, this paper looks into the potential applications of these tactics in Islamic financial systems.

The purpose of this literature review is to present a theoretical examination and real-world implementation of moral hazard in financing agreements with Islamic Financial Institutions (IFI). Additionally, by integrating viewpoints from other fields, including finance, economics, and Islamic law, this paper emphasizes the significance of risk mitigation techniques in tackling current Islamic financing issues. The study can offer a solid conceptual basis and tactical guidance on how to maximize risk management in Islamic financial systems thanks to this methodology.

C. Results and Discussion

1. Identifying Moral Hazard in Sharia Financing Contracts

On the operational side, Islamic banks face undeniable mudharabah financing problems. These problems can arise from asymmetric information and moral hazard. Moral hazard is a situation that occurs when the mudharib does not do things in accordance with what was agreed in the cooperation agreement (Rahardiansyah et al., 2022). Moral hazard occurs when there is a difference in information between Islamic banks and customers; customers know more about business developments than Islamic banks. Therefore, it is very likely that there will be irregularities, especially in the submission of inconsistent business reports (Yusuf et al., 2023). Therefore, the key to mudharabah financing is trust and honesty from both parties working together.

According to Syauqiyah (2025), from a risk management perspective, moral hazard is understood as a condition in which a party dares to take greater risks because they do not fully bear the consequences of their actions. Meanwhile, in the context of mudharabah financing, moral hazard occurs when customers are dishonest, misuse funds, or are irresponsible towards the financing that has been agreed upon with the bank. This is due to the limitations of the bank, which cannot directly control the business or obtain complete information related to the business activities.

Identifying moral hazard in Islamic financing contracts, particularly mudharabah contracts, is very important because the characteristics of this contract place the shahibul maal (capital owner) in a position that is vulnerable to opportunistic behavior by the mudharib (fund manager). Moral hazard can arise in various forms, including financial statement manipulation, concealment of profits, misuse of funds, and taking higher business risks than initially agreed upon. Rahardiansyah et al (2022) claim that since banks, as fund providers, have little ability to confirm the veracity of these claims, business statement falsification is the most prevalent sign of moral hazard. Moral hazard can also occur when the mudharib fails to conduct the business in a professional manner, which leads to losses that are eventually carried by the shahibul maal (Yusuf et

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al., 2023). In order for Islamic banks to create suitable control and mitigation procedures, it is imperative that they first map out the types of moral hazard.

2. Factors Causing Moral Hazard

The reasons behind moral hazard in Islamic finance are intimately tied to the features of contracts, consumer conduct, and bank oversight procedures. Moral hazard arises from information asymmetry between the bank, which provides the funds, and the customer, who manages the funds, under profit-sharing arrangements such mudharabah and musyarakah (Salman, 2024). In these circumstances, clients might falsify financial figures, hide a portion of their income, or utilize money for objectives not outlined in the contract. Additionally, persons who wish to engage in needless activities have more options due to the absence of bank monitoring.

Amal and Muhammadi (2022) assert that consumers who willfully break agreements such as by postponing payments, evading responsibilities, or misappropriating funds also engage in moral hazard. To safeguard the rights of Islamic financial institutions, certain acts are deemed infractions under Islamic law and may result in ta‘wīḍ punishments or ta‘zīr (educational punishment). This demonstrates that the issue of moral hazard is not solely caused by informational problems; rather, it is also connected to the ethics and dedication of clients to sharia contracts. According to Rouf (2021) research, dishonest client behavior, such as giving false information when requesting for financing or transferring cash without the bank's consent, might result in moral hazard at Bank Syariah Indonesia Kc Kedaton Bandar Lampung. This practice demonstrates that moral hazard in Islamic finance can arise in sale and buy agreements as well as outcome-based contracts, particularly when the bank denies clients authorization to use their money.

Moral hazard in Islamic finance can be attributed to three primary factors: (1) information asymmetry and oversight (Paldi, 2024); (2) opportunistic client behavior that breaches contracts (Amal and Muhammadi, 2022); and (3) dishonest financing application and utilization practices (Rouf, 2021). When creating mitigation techniques that adhere to the fairness and protection principles of the Islamic banking system, it is crucial to identify the variables that contribute to moral hazard.

3. Risk Mitigation Strategies Applied by Islamic Financial Institutions

To minimize moral hazard issues, Islamic banking in Indonesia has taken steps to strengthen risk mitigation, such as screening and monitoring all risky financing in order to minimize the negative impact of moral hazard (Rahardiansyah et al., 2022). The following are the measures taken by Islamic banking in Indonesia:

a. Screening is a series of analytical processes implemented at the beginning of the mudharabah financing procedure. The screening process is carried out to identify and assess the true character of prospective customers and other information to support the screening of mudharabah financing through the analysis of the documents submitted. In addition to screening the customer's character, it is also necessary to screen the project or business proposed by the customer to obtain financing. This allows Islamic banks to obtain a more detailed picture of the risk level of the proposed financing. In disbursing mudharabah financing, Islamic banks must pay attention to the 5C analysis, namely:
    1. Character, aims to assess the honesty and good faith of prospective mudharib.

2. Capacity, aims to assess the mudharib's ability to return the principal capital and profit sharing ratio.
3. Capital, the bank must review the capital owned by prospective customers so that it does not rely 100% on funds from mudharib.
4. Condition of Economy, Islamic banks are required to analyze economic conditions and ensure that there are no obstacles to the smooth running of the business proposed by prospective mudharib.
5. Collateral, in the form of guarantees from prospective mudharib, is used as security for mudharabah financing provided by Islamic banks.

b. Verification, to mitigate the risk of asymmetric information, particularly in the form of moral hazard, Islamic banks are required to conduct a rigorous verification process of the information and data provided by customers. This verification is not merely a formality; it serves as a critical mechanism to ensure that all information submitted is valid, reliable, and fully accountable. Through proper verification, Islamic banks strengthen their prudential practices and safeguard the principles of trust and transparency that underpin Islamic finance. The absence of such measures could expose banks to risks such as misrepresentation of business activities, misuse of financing funds, or discrepancies between reported and actual financial performance. Hence, verification functions as a preventive tool to reduce potential financial and operational losses while ensuring compliance with Sharia principles.

The verification process is typically carried out using several methods:

1. On The Spot (OTS), Visit direct observation at the customer's business site to validate the authenticity of reported business operations, financial conditions, and future prospects.

2. Trade Checking, cross-checking with third parties such as suppliers, buyers, and business partners to assess the credibility, consistency, and integrity of the customer's commercial transactions.
3. Personal Checking, reviewing the customer's personal reputation, track record, and character, either through internal banking data or external sources such as industry associations, community networks, and other relevant institutions.

c. Monitoring, serves as a crucial instrument in overseeing mudharabah financing, ensuring that any unfavorable developments that might reduce the quality or performance of financing can be identified as early as possible. In this sense, monitoring functions as an *early warning system* that allows Islamic banks to detect potential risks at an early stage and implement appropriate mitigation strategies to prevent financial losses. The essence of monitoring lies in its proactive approach: rather than waiting until problems escalate into defaults or significant financial setbacks, banks conduct regular supervision to anticipate issues and address them in a timely manner. Such efforts enable Islamic banks to safeguard the interests of both parties, preserve the integrity of the financing contract, and uphold the principles of prudence (*prudential principle*) and accountability in financial intermediation. Monitoring activities in mudharabah financing may include periodic evaluation of business performance, financial reporting analysis, site visits, and continuous communication with the entrepreneur (mudarib). These mechanisms allow banks to assess whether the financing is being used in accordance with the agreed contract and whether the business remains viable in generating profits.

d. The application of sharia ethics plays a pivotal role in mitigating the risk of moral hazard in mudharabah financing. In theory, Islamic ethical principles function as a form of self-regulation that guides both parties to act with honesty, integrity, and responsibility. By internalizing these principles, customers are encouraged to avoid deceitful practices, while the mudarib is expected to disclose profit and loss outcomes transparently in accordance with the agreed terms. Sharia ethics emphasize values such as truthfulness (*sidq*), trustworthiness (*amanah*), fairness (*'adl*), and accountability (*muhasabah*), which collectively act as preventive measures against opportunistic behavior. When these values are consistently applied, mudharabah contractors are more likely to fulfill their obligations in line with religious teachings, thereby ensuring that the contract is carried out fairly and equitably.

4. Effectiveness of Commonly Used Moral Hazard Risk Management

Many previous studies have discussed moral hazard in banking. One such study was conducted by Toni Bahtiar and Imam Sugema, entitled Asymmetric Information Problems in Islamic Banking System. The study concluded that one of the main characteristics of the credit market is the high level of asymmetric information between financial institutions and borrowers. This condition is particularly evident in cases of adverse selection, where banks often lack the ability or knowledge to distinguish between investment projects based on their inherent risk levels. Most commercial banks operating under an interest-based system have proven unable to overcome this problem of information asymmetry.

Research conducted by Rahmawati, (2018) entitled Indications of Moral Hazard in Financing Distribution in Islamic Banking in Indonesia emphasizes the importance of the principle of prudence in managing client funds as one of the main pillars in maintaining public trust in Islamic banks. Like other business institutions, Islamic banks are not entirely free from the potential for moral hazard and agency problems that can arise in the practice of fund distribution. This study aims to identify whether there is empirical evidence of moral hazard in the allocation of Islamic bank funds in Indonesia. Using descriptive survey methods, multiple regression analysis, and error-correction models on secondary data from 21 Islamic banks obtained from publications by Bank Indonesia and the Central Statistics Agency, this study found strong indications of moral hazard practices in Islamic bank operations. These findings reinforce that strengthening risk management, consistently applying the principle of prudence, and actively involving all stakeholders are crucial factors in minimizing negative impacts.

Based on Afrida, (2016) research, before approving mudharabah financing, Bank Tabungan Negara Syariah applies the 4C principle (character, capacity, capital, collateral) and 6A analysis (market aspect, marketing aspect, technical aspect, legal aspect, management aspect, and financial aspect) to assess the eligibility of prospective customers. An analysis of current economic conditions and future projections is also conducted so that the bank can estimate the sustainability of the business being financed, thereby minimizing the risk of default and keeping the Non-Performing Financing (NPF) rate low. The results of the study show that the 4C principle is sufficient if the prospective customer's economic conditions are normal, but the 6A analysis is used for a more in-depth assessment of business feasibility and legality. In line with this, Bank Mega Syariah also conducts direct field surveys on the background of customers and businesses to be financed, followed by a 5C analysis and business feasibility assessment. Although mudharabah financing does not require collateral in principle, Bank Mega Syariah still requires collateral as a moral hazard mitigation measure. This collateral is only liquidated if the customer is proven to have violated the terms of the contract, thereby covering the bank's potential losses due to moral hazard. This effort is in line with the views of Mustafa Edwin N. and Ranti Wiliasih, who emphasize that the careless use of third-party funds is a form of indirect moral hazard.

However, based on Jazilah) research, there are quite striking differences in the application of risk mitigation strategies between Bank Syariah Indonesia (BSI) and other Islamic banks. BSI applies the principle of prudence in disbursing working capital financing with mudharabah contracts through six stages, namely financing preparation, data collection, financing analysis, approval, disbursement (realization) of financing, and post-disbursement monitoring. The main difference lies in the focus of distribution, where BSI specifically distributes mudharabah financing only to Islamic cooperatives that have reliable business legality. This is considered safer because cooperative institutions that already have official legality are generally registered with Bank Indonesia and are under the auspices of a clear parent agency, thus ensuring the credibility of the business being financed. Thus, BSI's risk mitigation strategy emphasizes initial selection of business partners so that the financing provided does not cause moral hazard or default risk in the future.

In general, from the various mitigation strategies implemented by Islamic banks in Indonesia according to previous studies, it can be concluded that the mudharabah financing risk mitigation approach is divided into two categories, namely proactive strategy and reactive strategy. Proactive strategies are implemented before financing is provided, with the main objective of avoiding potential risks from the outset through feasibility analysis, customer selection, and the application of prudential principles. Meanwhile, reactive strategies are implemented after financing is disbursed, focusing on monitoring customer business development, preventing default risks, and taking action if moral hazard risks actually occur.

D. Conclusion

Moral hazard remains a major problem in Islamic financial institution financing. This is especially true for mudharabah contracts, which are vulnerable to information asymmetry that puts banks in a weak position. The results show that there are two types of mitigation strategies: proactive and reactive. Proactive involves screening, verification, feasibility analysis, and the application of prudential principles to prevent risk before financing is granted. Reactive involves monitoring, supervision, and the application of sharia sanctions to monitor after financing is provided. In addition, the technical banking process is complemented by the internalization of sharia ethics as a means of self-control. Therefore, moral hazard risk management is highly dependent on a combination of technical approaches and sharia values.

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