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Financing Risk Management: Determinants and Mitigation Strategies

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Abstract

Purpose – This study examines the determinants of murabahah financing risk and evaluates the implementation of risk management practices at KSPPS BMT NU Sejahtera Demak, an Islamic microfinance cooperative. It aims to identify key internal and external risk factors and assess the effectiveness of mitigation strategies in maintaining portfolio stability.

Methodology – A descriptive qualitative approach with a case study design was employed. Data were collected through semi structured interviews with management, financing staff, and customers, supported by direct observation and review of institutional documents, including standard operating procedures, financial reports, and murabahah portfolio data. Thematic analysis and triangulation techniques were used to ensure data credibility.

Findings – Murabahah financing risk arises from both internal and external sources. Internal risks include weak feasibility analysis, subjective and manual assessments, limited post-disbursement monitoring, and insufficient customer understanding of sharia contracts. External risks relate to unstable business income, economic fluctuations, natural disasters, and low repayment discipline. The institution has implemented mitigation measures such as field surveys, collateral requirements, periodic monitoring, financial education, and financing restructuring. These efforts have moderately reduced non-performing financing, although effectiveness remains limited by manual systems, lack of standardized risk tools, and constrained human resources.

Implications – Improving digital monitoring systems, objective risk assessments, and staff capacity is essential to strengthen risk control and ensure sustainability.

Originality – This study provides a case-based perspective on risk management in Islamic microfinance, a context less explored than Islamic banking.

Introduction

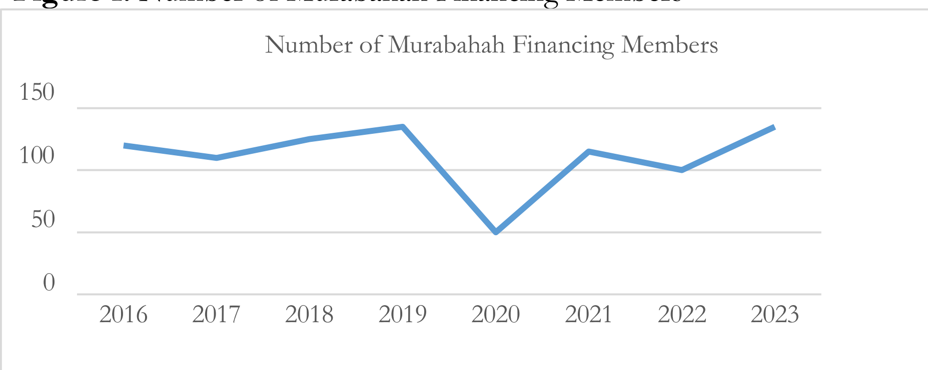
Islamic Financial Institutions in Indonesia constitute one of the largest financial sectors, with a presence that extends across almost all regions of the archipelago. Alongside this development, the number of Islamic Microfinance Institutions (IMFIs) has continued to grow in response to increasing public interest in sharia-compliant financial services. Islamic Microfinance Institutions operate by mobilizing and distributing funds while applying compensation mechanisms based on sharia principles, particularly trade-based contracts and profit-sharing arrangements.

In recent years, Islamic Microfinance Institutions have faced significant challenges, particularly due to an increasing number of customers experiencing repayment difficulties. This situation represents a critical test for financial institution leaders to develop effective strategies and solutions in order to reduce the level of non-performing financing (NPF) (Oktafia, 2018). One of the most important aspects in the development of Islamic banking products is microfinance financing. This type of financing is provided by Islamic microfinance institutions to the community, especially individuals from lower- and middle-income groups. The primary objective of this program is to support customers in developing and managing micro, small, and medium enterprises (MSMEs). Although microfinance financing can generate significant benefits for Islamic microfinance institutions, it also involves various risks that may create operational and financial challenges for these institutions (Simanjuntak, 2018).

Financing can be defined as the provision of funds or claims equivalent to funds based on agreements between financial institutions and other parties, which obligate the financed party to repay the funds or claims within a specified period, accompanied by compensation or profit-sharing mechanisms (Elwardah, 2020). According to the Financial Services Authority (Otoritas Jasa Keuangan, 2016), risk management is defined as a comprehensive and integrative framework for managing credit risk, market risk, operational risk, economic capital, and risk transfer to maximize organizational value. It encompasses a series of methodologies and procedures designed to identify, measure, monitor, and control risks arising from all business activities. Consequently, Islamic microfinance institutions must exercise prudence in their operations. Before approving financing, institutions are required to assess the credibility of prospective clients, understand the purpose of financing, and evaluate the business activities to be undertaken. Therefore, comprehensive risk analysis is essential prior to fund disbursement.

Murabahah financing, derived from the Arabic term ribḥ (profit), refers to a sale contract in which the seller explicitly discloses the acquisition cost and agreed profit margin. It is a cost plus sale agreement commonly used in Islamic financial institutions. Under Indonesian Banking Law No. 10 of 1998, financing activities are conducted based on agreements between banks and customers (Putri et al., 2023). The primary risk associated with murabahah financing relates to the possibility of delayed or defaulted payments by customers, representing a typical form of credit risk. In practice, murabahah financing is generally implemented through deferred payment schemes (muajjal), making credit risk the most significant exposure for Islamic financial institutions.

Figure 1. Number of Murabahah Financing Members



Source: KSPPS BMT NU Sejahtera KC Demak, 2024

Data from KSPPS BMT NU Sejahtera Demak indicate a consistent increase in the number of murabahah financing customers. The number of members rose from 110 in 2022 to 145 in 2023, demonstrating continuous growth in demand for this financing contract.

Problematic financing may arise from both internal and external factors. Internal factors originate within the institution, such as inadequate credit analysis or insufficient due diligence by staff. External factors stem from customers' circumstances, including default behavior, accidents, death, loss of income, or natural disasters such as floods. Additional indicators include weak business capacity, dishonest fund utilization, declining business performance, and limited managerial knowledge or experience among customers (Rahmany, 2017).

The development of Islamic banking is closely linked to the role of Islamic microfinance institutions such as Baitul Maal wat Tamwil (BMT), Islamic cooperatives, and other sharia-based financial entities. BMT operates as a non-bank financial institution under a cooperative framework, regulated by the Decree of the Minister of Cooperatives and SMEs No. 91/Kep/M.KUKM/IX/2004. Beyond mobilizing funds and managing social finance, BMT redistributes funds to the community through various financing schemes, including profit-sharing contracts (mudharabah, musyarakah), sale based contracts (murabahah, salam, istishna), lease-based contracts (ijarah), and benevolent loans (qard) (Nasfi et al., 2019).

Baitul Maal wat Tamwil (BMT) is one of the non-bank financial institutions that aims to provide financial services based on sharia principles in managing economic activities. BMT, which operates under the cooperative framework, was formally recognized in 2004; therefore, the practice of this type of non-bank Islamic financial institution is still relatively new within the broader community. Prior to the formal legalization of cooperatives operating under profit-sharing principles, many Muslim communities had already initiated the development of Baitul Maal wat Tamwil institutions. As a result, approximately 2,000 BMTs have now been established and are distributed throughout Indonesia. The financial transactions conducted by Baitul Maal wat Tamwil are widely utilized by small business groups, particularly those who face difficulties in accessing formal banking institutions. In addition, BMT has gained considerable public interest due to its simpler procedures, more flexible requirements, and relatively faster service processes compared to conventional financial institutions.

One example is KSPPS BMT Nusa Ummat Sejahtera, which operates as a sharia-based microfinance institution. This institution offers a variety of financial products designed to meet the needs of the community. Its activities include fund mobilization, such as educational savings, wadi'ah savings, time deposits, Hajj and Umrah savings, and special savings accounts. In addition, the institution provides fund distribution services, primarily through murabahah financing.

KSPPS BMT NUS offers four main financing products. The first is murabahah financing, which is a sale-based financing scheme in which KSPPS BMT NUS sells goods to its members with a predetermined profit margin agreed upon by both parties at the beginning of the contract. The second product is UMi financing (Ultra Micro Financing), which also utilizes a murabahah contract and is specifically designed for owners of productive micro-enterprises. This financing program is supported and facilitated by the government to strengthen the micro-enterprise sector. The third product is LPDB financing, which also applies a murabahah contract and is primarily intended for productive business actors, particularly micro, small, and medium enterprises (MSMEs). The final product is musyarakah financing, which is mainly provided to farmers in the form of seasonal financing. This scheme represents a partnership between two parties who jointly contribute capital to a business venture. The profits are shared according to the agreed ratio, while any potential losses are borne in proportion to each party's capital contribution. The third product is LPDB financing, which also applies a murabahah contract and is primarily intended for productive business actors, particularly micro, small, and medium enterprises (MSMEs).

The final product is musyarakah financing, which is mainly provided to farmers in the form of seasonal financing. This scheme represents a partnership between two parties who jointly contribute capital to a business venture. The profits are shared according to the agreed ratio, while any potential losses are borne in proportion to each party's capital contribution.

Table 1. Total Financing Portfolio of KSPPS BMT NU Sejahtera Demak

No	Product	2020	2021	2022	2023
1.	*Murabahah*	2.419.200.000	1.693.500.000	1.778.000.000	2.956.000.000
2.	Pembiayaan UMI	-	-	150.000.000	240.000.000
3.	Pembiayaan LPDB	-	-	200.000.000	240.000.000
4.	Musyarokah	-	-	-	-

Source: KSPPS BMT NU Sejahtera Demak, 2024

Based on the table above, it can be concluded that murabahah financing is the most frequently utilized financing product among members of KSPPS BMT NU Sejahtera Demak. The data indicate fluctuations in the amount of financing provided during the period 2020–2023, showing both increases and decreases over time. These findings provide an important reference for the management of BMT in minimizing potential risks. Prior to granting financing, the institution should conduct a comprehensive analysis of prospective customers or members. In addition, the BMT must ensure that members do not obtain overlapping financing from other institutions, particularly outside KSPPS BMT NU Sejahtera Demak, which may increase the risk of default. Furthermore, the data reveal that several financing products generated little or no financial return, indicating a lack of demand from members for those particular financing schemes. As the volume of financing distributed by KSPPS BMT NU Sejahtera Demak increases, the level of risk faced by the institution also rises. This risk becomes more pronounced during periods of economic disruption, such as the COVID-19 pandemic, which has significantly affected many economic sectors. One of the sectors most affected is murabahah financing, which has a substantial influence on the profitability of KSPPS BMT NU Sejahtera Demak. Conversely, if the targeted profit level is not achieved, the institution may experience financial losses.

Previous studies have examined risk management practices in murabahah financing. Mawardi (2023) identified both internal and external determinants of problematic financing and highlighted restructuring strategies such as rescheduling, reconditioning, and contract modification. The study identified several important findings regarding the mechanisms of prevention and detection that influence the resolution of financial problems at BMT UGT Sidogiri, Sidoarjo Larangan Branch. Financing problems were found to arise from both internal and external factors. Internal factors are related to institutional weaknesses, particularly the lack of thorough financial analysis conducted by the BMT during the financing assessment process. Meanwhile, external factors originate from circumstances beyond the institution’s control, such as unforeseen incidents and the lack of good faith among some members in fulfilling their financial obligations. To address these issues, BMT UGT Sidogiri Sidoarjo Larangan Branch implements several financing restructuring mechanisms, including rescheduling, reconditioning, and restructuring, which involve adjustments to the financing scheme and repayment structure in order to improve the members’ ability to fulfill their obligations. Nevertheless, many financing problems in this institution are ultimately linked to borrower negligence and the presence of bad faith among certain members, which contributes to financing defaults. Similarly, Belkhaoui et al. (2020) found that profit-sharing contracts may increase credit risk, while murabahah financing contributes positively to profitability, capitalization, and cost efficiency in Islamic banks.

Building upon these studies, the present research investigates murabahah financing risk management at KSPPS BMT NU Sejahtera Demak. This study focuses on identifying risk factors and examining mitigation strategies implemented by the institution, particularly amid economic uncertainty caused by the pandemic, inflation, and regulatory shifts. A qualitative approach is employed, with data collected through interviews with employees and customers to explore perceived risks and institutional responses. Understanding how risks are managed is crucial for strengthening the effectiveness and sustainability of Islamic microfinance institutions. Therefore, an in-depth analysis of risk management practices in murabahah financing is both necessary and timely.

Literature Review

Risk Management

According to Kasmir, (2014), risk management is a systematic process of identifying, measuring, and controlling risks that may disrupt an institution’s operations. In the context of Islamic financial institutions, risk management must be conducted prudently and in compliance with sharia principles, as it involves safeguarding entrusted funds belonging to members. The Financial Services Authority Otoritas Jasa Keuangan, (2015) emphasizes that risks should be mitigated through proactive and systematic approaches to prevent greater losses in the future. Thus, effective risk management serves as a fundamental element in maintaining institutional sustainability and financial stability.

Financing Risk in Islamic Financial Institutions

Financing risk refers to the potential loss arising from a customer’s failure to fulfill payment obligations. Antonio, (2001); Rahman et al., (2010); & Hyak et al., (2023) explains that financing risk in Islamic financial institutions may stem from moral hazard, misuse of funds, or customers’ inability to repay due to adverse economic conditions. Such risks must be identified and controlled from the early stages of the financing process, including screening, appraisal, and monitoring. Without proper management, financing risk may lead to an increase in non-performing financing (NPF), thereby threatening the institution's financial soundness.

Murabahah Contract

Murabahah is one of the most widely applied financing contracts in Islamic banking and microfinance institutions. Under this contract, the financial institution purchases goods required by the customer and subsequently sells them at a disclosed cost plus an agreed profit margin. According to the National Sharia Council Indonesian Ulema Council (DSN-MUI Fatwa No. 04/DSN-MUI/IV/2000), murabahah is defined as a sale transaction in which the acquisition price and profit are explicitly disclosed to the buyer. Despite its simplicity and predictability, murabahah financing is not free from risk. Potential risks include contractual non-compliance, misuse of financed goods, and delayed or defaulted payments, which primarily manifest as credit risk.

Determinants of Financing Risk

Several factors contribute to the emergence of financing risk. Ismail, (2010); & Sari (2016) identifies key determinants such as customer character, unstable business performance, weak financing analysis, and insufficient monitoring mechanisms. In addition, external factors including macroeconomic instability, market fluctuations, and natural disasters may significantly affect customers' repayment capacity. These determinants highlight the importance of comprehensive risk assessment that integrates both internal and external considerations.

Risk Mitigation Strategies

Risk mitigation strategies in Islamic financing include rigorous feasibility assessments, the application of prudential principles, and continuous post-disbursement monitoring. Sutedi, (2012) emphasizes the importance of combining preventive measures with corrective actions such as rescheduling and restructuring. Furthermore, Hyak et al., (2023) underline that the effectiveness of mitigation strategies depends on institutional commitment, staff competence, and the availability of reliable risk information systems. Complementary evidence from Indonesian Islamic financial practice also demonstrates that institutional efficiency and performance are closely associated with prudent risk governance and systematic control mechanisms (Rahmanto et al., 2024). These strategies are essential for minimizing losses and ensuring the sustainability of Islamic microfinance institutions.

Local Empirical Evidence on Islamic Financial Risk Several recent Indonesian studies provide contextual support for strengthening risk management in Islamic financial institutions. Rahmanto et al., (2024) show that the efficiency of Sharia rural banks improves when institutions apply structured monitoring and performance evaluation systems, implying that sound risk governance contributes directly to financial sustainability. In addition, Sudibyo et al., (2023) argue that risk mitigation in cooperative and microfinance settings should integrate preventive assessment, continuous supervision, and corrective restructuring to maintain institutional resilience. These findings reinforce the relevance of adopting comprehensive and locally grounded risk management approaches in BMT operations.

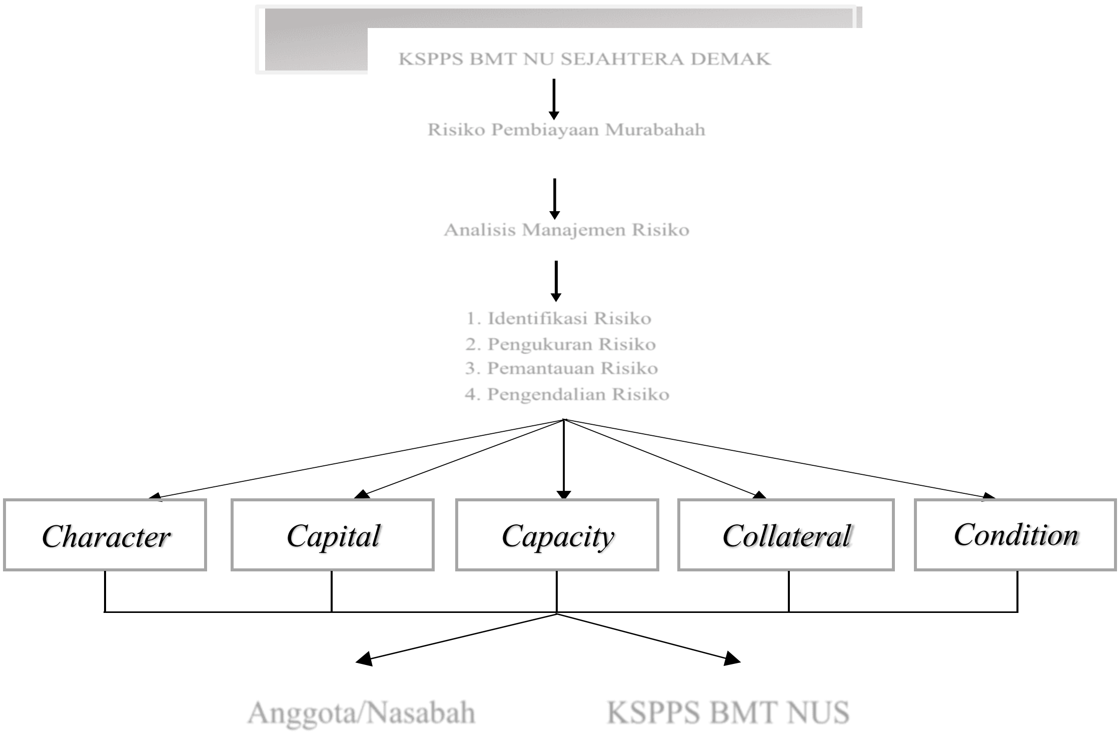
Conceptual Framework

The analytical framework of this study adopts the classical 5C principles of financing appraisal, which serve as indicators in assessing and mitigating financing risk:

1. Character: the integrity, honesty, and willingness of the customer to fulfill obligations;
2. Capital: the financial strength and own capital invested in the business;
3. Capacity: the customer's ability to generate cash flow for repayment;
4. Collateral: assets pledged to secure the financing;
5. Condition (of Economy/Business): external economic and business conditions affecting repayment performance.

These five dimensions collectively form the conceptual basis for identifying the causes of financing risk and designing appropriate mitigation strategies.

Figure 2. Conceptual Framework



Research Methods

This study employs a descriptive qualitative approach using a case study design. This approach is intended to obtain an in-depth understanding of how risk management practices are implemented by Baitul Maal wat Tamwil (BMT), particularly in the context of murabahah financing. A qualitative case study enables the researcher to explore institutional processes, managerial strategies, and contextual factors comprehensively within a real-life setting.

Data collection was conducted through multiple techniques to ensure the richness and credibility of the findings.

1. Interviews were conducted with BMT management personnel, financing staff, and selected customers. Semi-structured interviews were employed to allow flexible and exploratory discussions while maintaining focus on issues relevant to risk management and financing practices.
2. Observation was carried out through direct field visits to examine operational activities, including financing feasibility assessments, monitoring procedures, collection processes, and risk mitigation efforts implemented by the institution. This method enabled the researcher to capture actual practices and behaviors beyond verbal explanations.
3. Documentation involved the collection of secondary data, including standard operating procedures (SOPs), financial statements, and murabahah financing portfolio reports. These documents provided complementary evidence to support and validate information obtained through interviews and observations.

The collected data were analyzed using thematic analysis techniques, whereby information was systematically categorized into themes relevant to the research questions, such as risk identification, risk factors, and mitigation strategies. To ensure data validity and trustworthiness, source and method triangulation were applied, and interview findings were cross-checked with supporting documentary evidence. This process enhanced the credibility, consistency, and reliability of the study results.

Results and Discussion

Result

This study reveals that murabahah financing risk at KSPPS BMT NU Sejahtera Demak arises from a combination of internal and external factors. From the internal perspective, the most dominant risk factor is the weakness of customer feasibility analysis. The assessment process remains largely manual and subjective, resulting in limited data accuracy and a high likelihood of misestimation. Furthermore, supervision over the utilization of financing funds by customers is not yet optimal, creating opportunities for fund misuse and deviations from the intended purpose of financing.

Customer character also constitutes a critical determinant of financing risk, particularly in relation to payment discipline. A considerable number of customers fail to meet installment deadlines, while some demonstrate low levels of cooperation when contacted by the institution. These behavioral issues contribute directly to an increase in non-performing financing and operational burdens for the BMT.

From the external perspective, risks are exacerbated by customers' unstable or seasonal business activities, which generate irregular cash flows and reduce repayment capacity. Macroeconomic volatility such as rising prices of basic commodities as well as external shocks, including natural disasters, further undermine customers' business performance and financial stability. These conditions collectively heighten the likelihood of default. To mitigate these risks, the BMT has implemented several preventive and corrective strategies. First, field surveys are conducted to assess the actual conditions of prospective customers, including their residence, business operations, and social environment. This step aims to obtain more reliable qualitative information regarding customer eligibility. Second, the institution requires collateral as a safeguard to secure financing exposure. Third, periodic monitoring is carried out throughout the financing period to evaluate customers' repayment performance and business progress.

In addition to financial controls, the BMT also emphasizes non-financial approaches, such as providing financial education and business assistance, particularly for micro-entrepreneurs with limited managerial experience. When installment delays occur, the institution prioritizes a familial and persuasive approach, including direct visits, payment relief, rescheduling, and financing restructuring when necessary. These measures reflect the social and cooperative characteristics inherent in Islamic microfinance institutions.

Despite these mitigation efforts, several practical constraints remain. The recording and reporting systems are still predominantly manual, which complicates real-time risk tracking and reduces data reliability. Moreover, the institution lacks standardized risk measurement tools, such as data-driven scoring systems or formal risk assessment models. Human resource capacity also presents challenges, as not all financing staff have received specialized training in risk analysis and problematic financing management. Consequently, these limitations hinder the overall effectiveness of the implemented risk mitigation strategies.

Overall, the findings indicate that although KSPPS BMT NU Sejahtera Demak has adopted various risk management practices consistent with prudential principles, improvements in digitalization, standardized risk assessment systems, and staff competency development are necessary to enhance the robustness and sustainability of murabahah financing management.

Discussion

Based on the findings of this study, KSPPS BMT NU Sejahtera Demak faces various risks in murabahah financing, particularly the risk of customer default. The primary determinants of these risks include weaknesses in financing feasibility analysis, insufficient monitoring of fund utilization, and low payment discipline among members. In addition, external factors such as customers' unstable economic conditions and business performance that does not proceed as planned further exacerbate financing risk exposure.

To address these challenges, the BMT has implemented several risk mitigation strategies. These include conducting field surveys prior to financing disbursement, requiring adequate collateral, and strengthening the customer feasibility assessment process. Furthermore, the institution performs periodic monitoring and provides financial education and business assistance to members in order to enhance their managerial capabilities. In cases of delayed payments or defaults, the BMT adopts a persuasive and cooperative approach, including rescheduling installments and financing restructuring when necessary.

Overall, the implementation of these risk management practices has proven to be reasonably effective in reducing the level of non-performing financing. Nevertheless, the success of these measures largely depends on consistent enforcement and the active participation of members in fulfilling their financial obligations. With appropriate and sustained risk management strategies, the BMT can maintain the health of its financing portfolio and strengthen members' trust in the institution.

Conclusion

This study concludes that murabahah financing risk at KSPPS BMT NU Sejahtera Demak is driven by a combination of internal and external factors. Internally, the primary sources of risk include weaknesses in the feasibility assessment of prospective customers, insufficient supervision of fund utilization, and low levels of customer awareness and discipline in fulfilling payment obligations. Externally, fluctuations in customers' business conditions and income instability further reduce their repayment capacity.

To address these challenges, the institution has implemented several risk mitigation strategies, including field surveys, stricter feasibility assessments, collateral requirements, periodic monitoring, member education, and the handling of problematic financing through rescheduling and persuasive approaches. These measures have contributed to reducing non-performing financing and maintaining institutional stability.

Further findings reveal that problematic murabahah financing arises from both managerial and environmental factors. Internal weaknesses are largely associated with limited post-disbursement monitoring. Due to a shortage of field officers, regular supervision of customers after fund disbursement is not consistently conducted. Consequently, early warning signs such as declining business turnover or misuse of funds are often detected too late. In addition, insufficient customer education regarding sharia contracts, particularly murabahah, has led to misunderstandings about obligations and responsibilities. Some customers perceive financing as social assistance rather than a binding contractual commitment, indicating suboptimal dissemination of sharia principles.

Another internal issue concerns the inadequate application of the 5C analysis (Character, Capacity, Capital, Collateral, and Condition). In practice, subjective considerations and personal relationships occasionally influence financing decisions, potentially leading to moral hazard and weakening prudential standards. These conditions highlight the need for more objective and data-driven assessment mechanisms.

External risks also significantly affect financing performance. Many customers operate small and micro enterprises that are highly vulnerable to seasonal fluctuations, environmental conditions, and natural disasters such as flooding, which frequently occurs in the Demak region. When business income declines, repayment capacity automatically weakens. Moreover, limited financial discipline and the absence of strict sanctions encourage repeated payment delays. Some customers deliberately postpone payments despite having the financial capacity to repay, further exacerbating credit risk exposure. Dependence on a single source of income and unforeseen events such as natural disasters or disease outbreaks further increase default risk.

To mitigate these risks, KSPPS BMT NU Sejahtera Demak has adopted a combination of educational, technical, social, and spiritual approaches. Monitoring has been strengthened through scheduled visits and remote communication technologies. Educational initiatives include face-to-face counseling, brochures, and digital media to enhance understanding of murabahah contracts and repayment obligations. The institution has also begun improving customer character assessment by incorporating community references and introducing scoring systems to enhance objectivity. Financing decisions are increasingly reviewed collectively by committees to minimize personal bias, while internal training programs are provided to enhance staff competencies in risk management.

From the external perspective, restructuring facilities are offered to customers experiencing genuine business difficulties. These include installment deferment, extended financing periods, and adjusted payment schemes. The BMT also encourages income diversification and emergency savings among members. In several cases, religious and spiritual guidance is provided to reinforce moral responsibility and compliance with sharia principles, which has proven effective in restoring customer commitment.

An examination of financing collectability data between 2020 and 2023 indicates dynamic trends. Although total financing increased significantly in 2023 and the proportion of performing financing improved, the volume of substandard and non-performing financing remains relatively high. This suggests that, while risk management practices have produced positive outcomes, further improvements are still required to enhance overall portfolio quality.

The implementation of risk management at the institution generally follows four stages: risk identification, measurement, monitoring, and control. However, each stage exhibits certain limitations. Risk identification relies heavily on manual and subjective assessments. Risk measurement, although guided by the 5C principle, lacks standardized scoring or quantitative tools. Monitoring tends to be reactive rather than preventive, while risk control measures, though aligned with cooperative and sharia values, suffer from insufficient documentation and reporting. These shortcomings reflect a gap between theoretical risk management frameworks and practical implementation.

Overall, this study confirms that murabahah financing has the potential to enhance institutional profitability when supported by effective risk controls, as suggested in prior literature. Nevertheless, achieving such outcomes requires more systematic processes, digitalization of information systems, standardized risk measurement tools, and continuous staff training. Strengthening these aspects would enable the institution to shift from reactive to proactive, data-driven risk management, thereby ensuring greater sustainability, accountability, and compliance with sharia principles.

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