

# Analysis of Financing Risk Management and Mitigation Strategies on the Performance of Islamic Banks

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## Abstract

This study aims to analyze the application of financing risk management and mitigation strategies implemented by Islamic banks in maintaining their financial stability and performance. Using a qualitative descriptive approach with the case study method, data is collected through literature studies from various relevant sources, such as scientific journals, books and official documents. The results of the study show that Islamic banks face various risks, including contract risks, returns, investments, and strategic risks, which arise due to operational characteristics based on sharia principles. To anticipate potential risks of non-performing financing, Islamic banks implement mitigation strategies through financing feasibility analysis, the 5C principle. In addition, challenges in the era of digital transformation, such as the threat of cyberattacks and regulatory changes, encourage Islamic banks to strengthen internal control systems and increase technological readiness. These findings reinforce the understanding that effective risk management contributes positively to the asset quality and sustainability of Islamic banks' performance amid changing business dynamics.

**Keywords:** Risk management, Islamic banks, Non-performing Finance, Mitigation Strategies, Digital Transformation

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## INTRODUCTION

The term banking is familiar to the public, especially to those who have used bank services. Etymologically, banking comes from the word "bank", which is a business entity that has the main function of collecting funds from the public in the form of deposits, then redistributing them in the form of credit. Banks can also be understood as financial intermediaries, who distribute funds from those who have excess funds (surplus) to those who need funds (deficit) within a certain period of time (Purwanto, 2020). Thus, banking is an institution that carries out an intermediation function between the fund owner and the party that needs the funds.

According to Mutafarida, (2020) Sharia banks are also not immune to the risk of non-performing financing (NPF), so the right strategy is needed so that the NPF level remains under control and does not cause concern. In the face of these conditions, Islamic banking actually sees it as an opportunity, because the fund distribution system has its own characteristics. In general, Islamic banks distribute funds to customers through various financing products that can be classified into four main categories, namely: financing with the principle of buying and selling, rent-based financing, profit-sharing financing, and financing with contracts.

Sharia banking also often faces various types of risks inherent in all its business activities as a whole and real. These risks, both predictable and unpredictable, can have a negative impact on the income and capital of banking institutions. Based on Bank Indonesia Regulation No. 13/XXIII/PBI/2011 concerning banking institutions in Indonesia, there are two types of additional risks that are of concern, both for Islamic and conventional banks, namely yield risk and investment risk. (Mutafarida, 2020)

In Afriyeni & Susanto's research, (2020) banking institutions need to implement risk management, which consists of a number of stages and procedures used to identify, evaluate, monitor, and control potential risks that may arise from business activities. Bank Muamalat, as

the first pioneer of Islamic banking in Indonesia, has realized the importance of measures in managing risk in accordance with Islamic sharia principles.

In practice, Islamic banks today not only face common financial risks as experienced by other financial institutions, but are also faced with risks that come from the validity of the sharia contracts used. This uniqueness poses its own challenges, as some sharia products have a high level of complexity, while the available risk mitigation facilities are not fully in accordance with the operational characteristics of Islamic banks. This condition can cause weaknesses, so that Islamic banks are more vulnerable to risks compared to conventional banks. (Kurnia et al., 2023)

## **LITERATURE REVIEW**

### **1. Basic Principles of Sharia Banking**

Islamic banking is a financial institution that carries out an intermediation function based on Islamic principles. Its main activities include collecting funds from the community and redistributing in the form of financing based on sharia contracts, such as buying and selling (murabahah), lease (ijarah), profit sharing (mudharabah and musyarakah), and other contracts that do not conflict with sharia provisions (Mutafarida, 2020).

### **2. Implementation of Risk Management in Sharia Banks**

Risk management is a process that aims to recognize, measure, monitor, and control various potential risks that can harm institutions. In the context of Islamic banks, risk does not only come from financial factors, but also includes the conformity of the contract with Islamic sharia. Bank Indonesia also identifies two specific types of risks that are relevant in the sharia context, namely yield risk and investment risk (Afriyeni & Susanto, 2020).

### **3. Financing Risks and Feasibility Analysis**

Financing risk reflects the possibility of a customer's failure to meet payment obligations. Therefore, Islamic banks conduct a feasibility analysis to assess whether the financing is sharia-compliant, business-viable, and socially ethical. This analysis aims to reduce the potential for non-performing financing and ensure smooth refunds (Ilyas, 2020).

### **4. Risk Mitigation Measures**

Risk mitigation refers to preventive measures taken to minimize the negative impact of financing risks. In practice, Islamic banks use various approaches such as business assessment, the use of collateral, customer development, and continuous monitoring, without deviating from sharia principles (Hidayat, 2020).

### **5. The Influence of Risk Management on Bank Performance**

The implementation of effective risk management can improve bank performance by maintaining asset quality, reducing non-performing financing, and strengthening stakeholder trust. This has a positive impact on the financial stability and operational sustainability of Islamic banks (Kurnia et al., 2021).

## **METHODS**

This study applies a qualitative descriptive method with a case study approach. The main data is obtained through literature studies (library research) by reviewing and analyzing various

reference sources that are relevant to the research focus, such as books, scientific articles, previous research results, and related official documents. In the process of reviewing this literature, the researcher selects and evaluates literature in accordance with the theme raised. Data analysis is carried out using thematic analysis methods, which include the stages of data reduction, data presentation, and conclusion drawing systematically. This study also adopts a qualitative case study approach by examining the mitigation strategies applied, one of which is through the application of the 5C principle.

## **RESULTS AND DISCUSSION**

### **Contents of Results and Discussion**

Management is a crucial element in an organization to achieve goals effectively and efficiently. This process includes optimizing the use of various resources to achieve the set targets, as well as managing labor and other assets to the maximum. Every activity, whether carried out by individuals or companies, always contains an element of risk. In the business world, risk is closely related to the decision-making process and the courage of business actors in the face of uncertainty.

There is a strong relationship between the level of risk and the potential for profit; The greater the risk taken, the greater the chance of making a profit. The way one views risk reflects diverse perspectives on this phenomenon. Risk itself can be interpreted as the possibility of results that do not meet expectations, which have the potential to cause losses if not managed properly.

In general, risk is a form of uncertainty in achieving the desired outcome. In a business context, risk is often understood as the possibility of an event that can lead to a decrease in income or capital. Thus, risk is always related to the potential for unanticipated negative impacts. (Hidayat, 2020)

In general, Islamic banking is faced with typical types of risks because it must carry out its operations in accordance with sharia principles. Risks such as credit, market, operational, and liquidity are the main challenges, which arise due to differences in financial structures compared to conventional banks. In addition, the implementation of a profit-sharing system also complicates risk management in Islamic banking. (Syifa & Srisusilawati, 2022)

Risk management is also a systematic approach to identify, measure, evaluate, determine handling steps, monitor, and report various risks that arise in an activity or process. The important role of risk management lies in its ability to help achieve organizational goals and support the implementation of activities that contain potential opportunities, through measurable risk taking and minimizing the possibility of mistakes that have a big impact. This concept includes a series of stages that are systematically arranged, starting from the process of risk identification, assessment, mapping, preparation of alternative solutions, to monitoring and controlling the implementation of risk management strategies. (Hajar & Wirman, 2023)

### **I. Financing Risks in Islamic Banks**

Financing analysis is an assessment process to assess the feasibility of a financing proposal submitted by the customer. Through this analysis, it can be determined whether the proposed business is business-viable, in the sense that it has the potential as a source of return on the funds financed. In addition, the analysis also includes assessing whether the amount of financing proposed is in accordance with business needs, both in terms of nominal, purpose of use, and financing structure. This aims to minimize risks and ensure profits for Islamic banks and

customers. In the financing analysis process, it is important to pay attention to the ability and willingness of the customer to fulfill his obligations, as well as ensure that all aspects of financing are in accordance with sharia principles.

In distributing financing, Islamic banks apply measures that do not harm banks and customers who have entrusted their funds. One way to minimize the risk of non-performing financing is through financing analysis. This process is a very important preventive measure, and if done professionally, it can serve as an initial filter to avoid the occurrence of problematic financing. Assessing the feasibility of financing is the main and crucial aspect in the decision-making process, because it has a major impact on the quality of financing and the smooth return of funds. (Usanti, 2015)

In the economic and financial fields, risk can be categorized in various forms. One way to classify it is to separate business risk and financial risk. Business risks arise due to uncertainty stemming from the company's operational characteristics. This risk is related to elements that affect the market conditions of the product. Meanwhile, financial risk is an uncertainty that arises due to potential losses in the financial market due to fluctuations in various financial variables. (Ilyas, 2019)

According to Muhammad Syafii Antonio, the purpose of the financing analysis is to convince the bank that the financing application submitted is really feasible, trustworthy, and not fabricated or fictitious. Before a financing is approved, there are a number of important things that must be ensured first, including:

**Table 1.1 Financing Risk Check Model in Sharia Banks**

No.	Assessment Questions	True (✓)	False (X)	Notes/Advanced Actions
1.	Are financing objects included in the halal category according to sharia law?	✓		DSN MUI fatwa related to the business sector
2.	Does the project have the potential to harm society in general (e.g. damaging the environment, monopoly)?		X	Evaluation of EIAs, social risks, etc.
3.	Do business activities contain elements of immoral acts or deviate from Islamic ethics?		X	Do business activities contain elements of immoral acts or deviate from Islamic ethics?
4.	Are projects related to gambling (maysir) or speculative activities (gharar) prohibited?	✓		Example: trading derivatives without the underlying asset
5.	Is the business involved in the production/distribution of illegal weapons or weapons for mass murder?		X	Due diligence is required on the product and its market objectives
6.	Does the project have a negative impact on Islamic teachings, either directly or indirectly?		X	Evaluation of content, brand image, and social influence

Source: Author

Instructions for Use:

- 1) The answer "X" to one of the indicators indicates a high sharia risk, it is necessary to reject or restructure the scheme.
- 2) This check can be completed with supporting documents, such as:- DSN MUI Fatwa- Environmental impact report- Internal sharia audit- Opinion of the Sharia Supervisory Board (DPS)

### 3) Mitigation Strategy for Sharia Bank Performance

Strategic risk is a risk that arises due to the improper implementation of strategies, errors in business decision-making, or the bank's non-compliance with changes in applicable regulations and regulations. To manage these risks, it is necessary to implement a consistent internal control system. Strategic risk is usually characterized by failure to achieve predetermined business targets, both in financial and non-financial aspects. (Winardi, 2020)

Strategic risks can arise from various sources, such as weaknesses in strategy design, inaccuracies in its preparation, limitations of management information systems (SIM), lack of in-depth analysis of internal and external conditions, setting strategic objectives that are too ambitious, errors in strategy implementation, and inability to respond to changes in the business environment. (Fachryana, 2020)

Bank Indonesia, through PBI No. 13/23/PBI/2011, classifies strategic risks as a type of risk that stands alone, separate from other risks. In the regulation, strategic risk is defined as a risk that arises due to errors in making and/or implementing strategic decisions, as well as failure to respond to changes in business environmental conditions. Strategic risk is included in the category of business risk, which is different from financial risk such as market risk or credit risk. Banks' inability to manage strategic risks can have a major impact on other risk profiles. For example, if a bank sets a strategy to increase Third Party Funds (DPK) by offering high interest rates, this can lead to increased liquidity risk and interest rate risk. (Dewi & Sopingi, 2024)

In general, strategic risks can arise due to several things, such as strategies that are not aligned with the bank's vision and mission, incomplete analysis of the strategic environment, and incompatibilities between strategic plans at various levels of the organization. In addition, these risks can also occur due to inability to deal with technological changes, macroeconomic conditions, dynamic market competition, and new policies from the competent authorities. In general, customers face a variety of security threats when using digital banking services, including the risk of cyberattacks, phishing, malware, and denial of service (DoS) attacks.

This risk includes irresponsible parties' attempts to access, damage, or steal critical data and information from the digital banking system. While digital technology offers convenience, its existence also opens up loopholes against threats such as cyberattacks, phishing, and malware that can threaten the security of customer data. (Andini & Fitri, 2025)

While the opportunity to develop digital banking services to meet the needs of the community is enormous, there are also challenges. These challenges can come from internal or

external factors. Internally, challenges include changes in work culture and mindset in the organization. Digital banking industry players also need to prepare information technology infrastructure and reliable cybersecurity systems. In addition, the development of financial features and services must be able to keep up with the dynamics of changing customer needs. On the other hand, external factors include challenges in dealing with variations in the level of financial literacy, digital literacy, and technology adoption capabilities of the intended market segment. (Hassandi et al., 2025)

## CONCLUSION

Islamic banks face a variety of financing risks stemming from the unique characteristics of sharia-principle-based operations, including contract, yield, and investment risks. To manage these risks, Islamic banking institutions must implement risk management systematically, starting from identification to risk control. This study shows that financing feasibility analysis is an important instrument in preventing problematic financing. In addition, risk mitigation strategies, such as the application of the 5C principle, customer coaching, and continuous monitoring, have proven to be crucial in maintaining the financial performance and stability of Islamic banks.

In the context of digital transformation and external challenges such as cyberattacks and regulatory changes, Islamic banks are also required to strengthen internal control systems and increase technological readiness. Appropriate mitigation strategies that are responsive to strategic and digital risks are key factors to maintain and improve the performance of Islamic financial institutions in the midst of competition and complex market dynamics.

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