

# Moral Hazard in Mudharabah Financing: Evidence from Bank Syariah Indonesia



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## Abstract

This study examines the phenomenon of moral hazard in mudharabah financing, which remains a critical challenge in Islamic banking practices, particularly within Bank Syariah Indonesia. Although mudharabah is theoretically designed as a profit-sharing financing instrument that upholds the principles of fairness and transparency within Islamic Finance, in practice it is still exposed to information asymmetry that creates opportunities for opportunistic behavior by customers. Previous studies have largely overlooked the micro-level dynamics of moral hazard at the branch level using a contextual qualitative approach, especially in socio-economic settings such as Palopo. This study aims to analyze the forms, determinants, relational patterns, impacts, and mitigation strategies of moral hazard in mudharabah financing. A qualitative case study approach was employed at Bank Syariah Indonesia, Palopo Branch, with data collected through in-depth interviews, observation, and documentation, and analyzed using thematic analysis guided by Agency Theory. The findings reveal that moral hazard manifests in forms such as profit underreporting, financial statement manipulation, and misuse of funds, driven by information asymmetry, limited monitoring, low financial literacy, and strong trust-based social relations. The impacts include financing inefficiency, declining trust, and a strategic shift toward lower-risk financing instruments. This study contributes by developing a contextual model of moral hazard in branch-level Islamic banking operations and provides important implications for strengthening governance in profit-sharing financing systems.

Keywords:

*Moral Hazard, Mudharabah, Bank Syariah Indonesia*

## 1. INTRODUCTION

International labor migration has become a common economic strategy among families in developing countries, including Indonesia. This phenomenon is primarily driven by limited domestic employment opportunities and the expectation of improving household welfare through remittances. In this context, remittances serve not only as a source of income but also as a means to enhance children's access to education. However, the relationship between improved economic conditions and educational outcomes is not always linear (Khoiruddin & Pratomo, 2024).

In recent decades, the global financial industry has witnessed a significant expansion of Islamic banking as an alternative to conventional interest-based systems. Among various financing contracts, mudharabah which is grounded in profit-and-loss sharing principles has been widely

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recognized as a more equitable and risk-sharing mechanism. However, despite its theoretical advantages, the practical implementation of mudharabah financing remains vulnerable to various challenges, particularly the emergence of moral hazard behavior among fund managers (mudharib). This issue is primarily driven by information asymmetry, where the entrepreneur possesses more accurate and timely information about business performance than the capital provider (Annizar & Junarsin, 2025; Sholihah, 2021).

At the international level, the issue of moral hazard has become a central concern in the study of Islamic Finance, particularly in relation to profit-sharing contracts. Empirical studies across different jurisdictions indicate that mudharabah financing carries a higher risk profile compared to debt-like instruments, largely due to the limited monitoring capacity of financial institutions. In many cases, entrepreneurs may underreport profits or manipulate financial statements to reduce the amount of profit shared with the bank. Such opportunistic behavior undermines the fairness and efficiency of the contract and poses a serious challenge to the sustainability of Islamic financial institutions (Masita et al., 2025; Syauqiyah, 2025).

From a theoretical perspective, this phenomenon can be explained through Agency Theory, which highlights the inherent conflict of interest between principals (banks) and agents (entrepreneurs). When monitoring mechanisms are weak and incentive structures are misaligned, agents are more likely to act in their own self-interest at the expense of principals. This agency problem is not confined to a specific region but represents a global issue affecting the performance and credibility of Islamic banking systems worldwide (Sholihah, 2021).

In Indonesia, the development of Islamic banking has shown a positive trajectory, supported by increasing public awareness and institutional strengthening. The establishment of Bank Syariah Indonesia as a result of the merger of state-owned Islamic banks marks a significant milestone in enhancing the competitiveness of the national Islamic financial industry. Nevertheless, despite this progress, profit-sharing financing such as mudharabah continues to face substantial challenges, particularly in relation to moral hazard risks (Sodik et al., 2023).

Empirical evidence in Indonesia suggests that Islamic banks tend to be more cautious in extending mudharabah financing due to the high uncertainty associated with the honesty and transparency of customers. In practice, many entrepreneurs fail to provide accurate financial reports, making it difficult for banks to determine the true level of business profitability. As a consequence, Islamic banks often prefer less risky financing schemes such as murabahah, leading to a relatively low proportion of mudharabah financing within the overall portfolio. This condition indicates a gap between the ideal principles of Islamic finance and their practical implementation (Yusuf et al., 2023).

Furthermore, the persistence of moral hazard in Indonesia is also influenced by limitations in monitoring systems and regulatory enforcement. Although banks have implemented various risk mitigation strategies, such as stricter screening and evaluation processes, these measures are not always sufficient to eliminate opportunistic behavior. In addition, factors such as financial literacy, business ethics, and cultural practices play a significant role in shaping the behavior of customers, thereby contributing to the complexity of moral hazard issues in Islamic banking (Anggraeni, 2024).

At the local level, the phenomenon of moral hazard in mudharabah financing can also be observed in the operations of Islamic banking institutions in Palopo. As a region characterized by the growth of micro, small, and medium enterprises (MSMEs), the demand for partnership-based financing schemes is relatively high. However, the implementation of mudharabah contracts often encounters practical constraints, particularly in ensuring transparency and accountability in financial reporting by customers (Syauqiyah, 2025)(Sari et al., 2024).

In the context of Bank Syariah Indonesia in Palopo, indications of moral hazard can be identified through discrepancies between reported and actual business performance. Moreover, the limited capacity for intensive monitoring, combined with close social relationships between bank officers and customers, may further influence financing practices at the local level. These conditions highlight the importance of conducting an in-depth investigation into moral hazard in mudharabah

financing, not only to understand its empirical dynamics but also to provide insights for improving the governance and sustainability of Islamic banking practices (Sodik et al., 2023).

Despite the growing body of literature on moral hazard in Islamic banking, particularly within the domain of Islamic Finance, several critical gaps remain insufficiently addressed. Existing studies have predominantly focused on conceptual discussions or quantitative assessments of risk without deeply exploring the actual behavioral practices of customers in profit-sharing contracts such as *mudharabah*. Moreover, while the issue of moral hazard is often explained through the lens of Agency Theory, empirical investigations that capture the nuanced interactions between banks and customers in real-world contexts are still limited. In particular, there is a lack of in-depth qualitative evidence that reveals how moral hazard manifests in daily financing practices, especially in developing countries where informal business structures and limited financial transparency are prevalent (Annizar & Junarsin, 2025; Syauqiyah, 2025).

Furthermore, prior research in the Indonesian context has largely concentrated on macro-level analyses or comparative studies across Islamic financial institutions, with relatively little attention given to institution-specific and location-based dynamics. The role of Bank Syariah Indonesia as the largest Islamic bank in Indonesia has not been extensively examined in terms of how moral hazard operates within its *mudharabah* financing schemes, particularly at the branch level. In addition, localized socio-cultural factors, such as trust-based relationships and community proximity, which may significantly influence customer behavior, remain underexplored in the literature. Therefore, this study seeks to fill these gaps by providing an in-depth, context-specific analysis of moral hazard practices in *mudharabah* financing at Bank Syariah Indonesia in Palopo, offering both empirical insights and theoretical contributions to the broader discourse on Islamic banking governance (Sodik et al., 2023; Yusuf et al., 2023).

This study offers a novel contribution to the literature on moral hazard in Islamic Finance by moving beyond dominant quantitative and conceptual approaches and providing a context-rich, micro level analysis of *mudharabah* financing practices within Bank Syariah Indonesia. Unlike prior studies that primarily frame moral hazard through generalized assumptions of Agency Theory, this research uncovers how such behavior is socially constructed and operationalized in real financing interactions at the branch level, particularly within a localized setting such as Palopo. It uniquely integrates institutional, behavioral, and socio-cultural dimensions such as trust-based relationships, informal business practices, and limited financial transparency into the analysis of profit-sharing contracts. By doing so, the study not only refines the understanding of moral hazard in *mudharabah* financing but also proposes a more grounded and context-sensitive perspective that bridges the gap between theoretical ideals and practical realities in Islamic banking.

The urgency of this study lies in the growing need to strengthen the integrity and sustainability of profit-sharing financing within Islamic Finance, particularly in the face of persistent moral hazard risks. As *mudharabah* represents a core instrument that differentiates Islamic banking from conventional systems, the continued prevalence of opportunistic behavior threatens not only the fairness of profit distribution but also the credibility of Sharia-compliant financial practices. In the Indonesian context, where Bank Syariah Indonesia plays a pivotal role in advancing the Islamic financial ecosystem, unresolved moral hazard issues may hinder the optimization of profit-sharing contracts and reinforce the dominance of less risky, non-participatory financing schemes. Moreover, at the practical level, the absence of context-specific insights particularly at the branch level such as in Palopo limits the effectiveness of existing risk mitigation strategies. Therefore, this study is urgently needed to provide empirical evidence and actionable insights that can support the development of more transparent, accountable, and resilient *mudharabah* financing practices, thereby enhancing both institutional performance and public trust in Islamic banking.

This study aims to conduct an in-depth analysis of moral hazard practices in *mudharabah* financing at Bank Syariah Indonesia, particularly within the operational context of Palopo. Specifically, this research seeks to identify the forms of moral hazard that arise in the relationship between the bank as the capital provider and customers as business managers, as well as to examine the factors that influence such behavior, including information asymmetry, monitoring mechanisms,

and local socio-cultural dynamics. Furthermore, this study aims to analyze the impact of moral hazard practices on the effectiveness of mudharabah financing and its implications for the performance and sustainability of Islamic banking. By employing the perspective of Agency Theory, this research is expected to provide a comprehensive understanding and generate strategic recommendations to minimize moral hazard risks and enhance the governance quality of profit-sharing financing (Annizar & Junarsin, 2025; Syauqiyah, 2025).

This study is expected to generate significant theoretical and practical impacts on the development of Islamic banking, particularly in strengthening the implementation of profit-sharing contracts within Islamic Finance. From a theoretical perspective, the findings will enrich the discourse on moral hazard by offering a more context-sensitive understanding that extends beyond the conventional framework of Agency Theory, incorporating socio-cultural and behavioral dimensions into the analysis of mudharabah financing. From a practical standpoint, this research provides valuable insights for Bank Syariah Indonesia and other Islamic financial institutions in designing more effective monitoring mechanisms, improving risk management strategies, and enhancing transparency in customer reporting. In addition, the study may serve as a reference for regulators and policymakers in formulating more adaptive and context-driven policies to mitigate moral hazard risks. Ultimately, the research contributes to strengthening public trust, optimizing the role of profit-sharing financing, and supporting the long-term sustainability of Islamic banking both at the national and global levels (Annizar & Junarsin, 2025; Syauqiyah, 2025; Yusuf et al., 2023).

A growing body of prior research has examined the issue of moral hazard in Islamic banking, particularly within profit-sharing contracts such as mudharabah. Existing studies generally highlight that information asymmetry between financial institutions and customers creates significant challenges in ensuring fair profit distribution and transparent reporting. Several empirical findings indicate that customers often possess greater control over business information, which may lead to opportunistic behaviors such as profit underreporting or manipulation of financial statements. While these studies provide important insights, most of them rely heavily on quantitative approaches or secondary data, thereby offering limited understanding of how moral hazard is actually practiced and negotiated in real financing interactions. Within the broader discourse of Islamic Finance, there remains a need for more context-specific and behavior-oriented analyses that capture the complexity of customer–bank relationships, particularly in developing economies where informal business practices are prevalent.

From a theoretical standpoint, this study is primarily grounded in Agency Theory, which explains the inherent conflict of interest between principals (banks) and agents (customers) under conditions of asymmetric information and limited monitoring. In the context of mudharabah financing, this theory is highly relevant as it conceptualizes the potential for agents to act opportunistically when their actions cannot be fully observed or verified. However, this study extends the traditional agency framework by integrating perspectives from behavioral and institutional approaches, recognizing that moral hazard is not solely driven by economic incentives but is also shaped by social relationships, ethical values, and local cultural contexts. By situating the analysis within the operational environment of Bank Syariah Indonesia, this research seeks to provide a more comprehensive theoretical and empirical understanding of moral hazard in Islamic banking practices..

## **2. METHODOLOGY**

The study employs a qualitative approach with a case study design to obtain an in-depth understanding of moral hazard practices in mudharabah financing. This approach is chosen because the phenomenon under investigation involves behavioral aspects, motivations, and social interactions between the bank and its customers, which cannot be adequately captured through quantitative methods. The research focuses on Bank Syariah Indonesia, Palopo Branch, as the object of study, considering that the region is dominated by micro, small, and medium enterprises (MSMEs), which are the primary targets of profit-sharing financing, and also possesses socio-cultural characteristics that may influence financing relationships.

The informants in this study consist of eight individuals, including three internal bank representatives (account officers and financing analysts) and five customers who have received mudharabah financing. Informants were selected using purposive sampling based on the following criteria: (1) having direct experience in mudharabah financing processes, (2) actively involved in managing or supervising financing activities, and (3) willing to provide open and detailed information. Data were collected over the period from January to March 2026 through in-depth interviews, observation, and documentation. Semi-structured interviews were conducted to allow for flexible and comprehensive data exploration.

To ensure data validity, this study applies source and method triangulation by comparing information obtained from different informants and cross-checking interview results with observational and documentary evidence. In addition, member checking was conducted with selected informants to verify the accuracy of the researcher's interpretations. The collected data were analyzed using thematic analysis with an interactive model consisting of data reduction, data display, and conclusion drawing. The analysis is further supported by the framework of Agency Theory to explain the relationship between the bank as the principal and the customer as the agent in mudharabah financing.

### 3. RESULT

Before presenting the main findings related to moral hazard practices, it is important to provide a general overview of the research object as the analytical context. This study was conducted at Bank Syariah Indonesia, Palopo Branch, which operates as part of Indonesia's national Islamic banking network with a focus on Sharia-compliant financing. One of the primary financing schemes employed is mudharabah, a partnership contract in which the bank acts as the capital provider (shahibul maal) and the customer serves as the business manager (mudharib) under a profit-sharing arrangement. In practice, this type of financing is predominantly extended to micro, small, and medium enterprises (MSMEs) in Palopo, operating across various sectors such as trade, services, and other productive activities.

Operationally, the implementation of mudharabah financing involves several stages, including feasibility assessment, contract agreement, and ongoing reporting and monitoring mechanisms carried out by the bank. However, the characteristics of customers—largely consisting of MSME actors with relatively simple financial record-keeping systems—combined with the bank's limited capacity to directly supervise business activities, create conditions conducive to information asymmetry. Furthermore, the close social and cultural relationships within the local context of Palopo influence the interaction patterns between bank officers and customers, which in some cases may weaken formal control mechanisms in financing relationships. These conditions provide an important foundation for further examining the forms of moral hazard that emerge in the practice of mudharabah financing.

#### 3.1. Forms of Moral Hazard

The findings reveal that moral hazard practices in *mudharabah* financing at Bank Syariah Indonesia, Palopo Branch, manifest in several forms reflecting opportunistic customer behavior. The most dominant form identified is profit underreporting, where customers report lower income than actual earnings to reduce the profit-sharing portion owed to the bank. In addition, practices such as financial statement manipulation, misuse of funds, and delayed reporting were also observed.

This finding is supported by a statement from a bank officer:

*"Beberapa nasabah memang tidak melaporkan keuntungan sebenarnya, sehingga bagi hasil yang diterima bank menjadi lebih kecil."* (A01)

Similarly, a customer acknowledged:

*"Kadang laporan disesuaikan dengan kondisi, karena kalau terlalu besar nanti bagi hasilnya juga besar."* (C2).

These findings indicate that despite the trust-based nature of *mudharabah*, there are practical deviations driven by self-interest.

**Table 1. Forms of Moral Hazard in Mudharabah Financing at Bank Syariah Indonesia**

No	Forms of Moral Hazard	Description of Findings	Field Indications
1	Profit underreporting	Customers report lower profits than actual earnings	Discrepancy between bank estimates and reported income
2	Financial statement manipulation	Financial data are inaccurate or intentionally altered	Inconsistent and poorly documented reports
3	Misuse of funds	Funds are not utilized according to the <i>mudharabah</i> agreement	Funds diverted to personal or unrelated business use
4	Lack of transparency	Customers do not fully disclose business information	Reluctance to share financial data
5	Reporting delays	Financial reports are submitted late or irregularly	Monitoring process becomes ineffective

Source: Research result

These findings suggest that moral hazard in *mudharabah* financing is not merely a technical issue but is deeply rooted in customer behavior and motivation in managing their businesses. From the perspective of Agency Theory, this phenomenon reflects a conflict of interest between the bank as the *principal* and the customer as the *agent*, where the latter possesses superior information regarding business performance and may exploit this advantage to conceal relevant information. Practices such as profit underreporting and financial manipulation can be interpreted as strategic actions taken by customers to maximize personal gain. Furthermore, weak monitoring mechanisms and a high reliance on trust within financing relationships further exacerbate the potential for such opportunistic behavior. Therefore, these findings highlight that moral hazard in *mudharabah* financing is shaped not only by structural limitations but also by behavioral factors and the socio-relational context embedded in the interaction between banks and customers.

### 3.2. Factors Causing Moral Hazard

Students' psychological conditions vary significantly, ranging from feelings of longing and sadness to emotional adaptation. The findings indicate that moral hazard is driven by multiple factors,

including information asymmetry, limited monitoring, low financial literacy, and socio-cultural proximity. Among these, information asymmetry emerges as the most critical factor, as customers possess more accurate knowledge of their business performance than the bank.

As expressed by one informant:

*“Kami sulit memantau usaha nasabah secara langsung, sehingga hanya bergantung pada laporan mereka.” (A02)*

Another informant added:

*“Tidak semua nasabah punya pencatatan keuangan yang rapi, jadi kadang laporan itu hanya perkiraan saja.” (C3)*

These conditions create opportunities for opportunistic behavior, particularly in environments with weak financial documentation and limited supervision.

**Table 2. Factors Contributing to Moral Hazard in Mudharabah Financing at Bank Syariah Indonesia.**

No	Factors	Description of Findings	Field Evidence
1	Information Asymmetry	Customers have superior access to business information compared to the bank	Discrepancy between actual and reported financial performance
2	Limited Monitoring	Bank faces constraints in supervising customer business activities	Infrequent business visits and reliance on self-reported data
3	Low Financial Literacy	Customers lack understanding of profit-sharing principles	Misinterpretation of reporting obligations
4	Weak Reporting Systems	Absence of standardized financial recording among MSMEs	Informal and inconsistent financial documentation
5	Socio-Cultural Proximity	Close personal relationships influence professional interactions	High reliance on trust over formal verification

Source: Research result

The identified factors demonstrate that moral hazard in *mudharabah* financing is a multidimensional issue shaped by both institutional limitations and behavioral dynamics. From the perspective of Agency Theory, information asymmetry emerges as the primary driver, as it enables customers (agents) to exploit their informational advantage over the bank (principal). The presence of limited monitoring mechanisms further weakens the bank’s ability to detect and prevent opportunistic behavior, thereby reinforcing the agency problem. Additionally, low financial literacy and weak reporting systems highlight the structural challenges

inherent in financing MSMEs, where formal financial management practices are often absent. Importantly, the influence of socio-cultural proximity introduces a contextual dimension that extends beyond traditional economic explanations, suggesting that trust-based relationships, while valuable, may inadvertently reduce the effectiveness of formal governance mechanisms. Therefore, these findings underscore the need for a more integrated approach that combines improved monitoring systems, enhanced customer education, and context-sensitive governance strategies to mitigate moral hazard in Islamic banking practices.

### 3.3. Bank-Customer Relationship Pattern

The findings reveal that the relationship between the bank and customers in *mudharabah* financing at Bank Syariah Indonesia, Palopo Branch, is characterized by a hybrid interaction pattern that combines formal contractual arrangements with strong informal and social elements. While the financing relationship is formally governed by contractual agreements, in practice, interpersonal trust and social proximity play a significant role in shaping interactions. In many cases, bank officers rely not only on formal financial reports but also on personal judgment and relational familiarity with customers. This trust-based approach, while facilitating smoother communication and customer engagement, may simultaneously reduce the rigor of monitoring and verification processes. Furthermore, the findings indicate that customers often perceive the relationship as flexible and negotiable, which may influence their level of compliance with reporting obligations. Such relational dynamics reflect a shift from purely institutional control toward socially embedded interactions in local banking practices.

The relationship between the bank and customers is characterized by a combination of formal contractual arrangements and strong informal trust-based interactions. While contracts provide formal structure, in practice, interpersonal relationships significantly influence monitoring and decision-making processes.

This is reflected in the following statement:

*"Karena sudah saling kenal, biasanya kami lebih percaya saja tanpa terlalu banyak pengecekan."* (A03)

A customer also noted:

*"Hubungannya lebih seperti kemitraan, jadi tidak terlalu kaku seperti bank konvensional."* (C1)

This relational dynamic fosters cooperation but may simultaneously weaken formal control mechanisms.

**Table 3. Patterns of Bank–Customer Relationships in Mudharabah Financing at Bank Syariah Indonesia**

No	Relationship Pattern	Description of Findings	Field Evidence
1	Formal Contractual Relationship	Financing is based on formal <i>mudharabah</i> agreements	Existence of written contracts and agreed profit-sharing terms
2	Trust-Based Interaction	Strong reliance on interpersonal trust	Limited verification due to confidence in customer integrity
3	Social Proximity	Close social and cultural ties between	Frequent informal communication and familiarity

4	Flexible Compliance	bank and customers Customers perceive rules as adaptable	Delays or adjustments in reporting without strict enforcement
5	Relational Monitoring	Monitoring based on relationships rather than strict systems	Dependence on personal judgment over structured audits

Source: Research result

The identified relationship patterns indicate that the interaction between the bank and customers in *mudharabah* financing extends beyond formal contractual boundaries and is deeply embedded in social and relational contexts. From the perspective of Agency Theory, such dynamics can both mitigate and exacerbate agency problems. On one hand, trust-based relationships may reduce opportunistic behavior by fostering mutual commitment; however, on the other hand, excessive reliance on trust can weaken formal control mechanisms and increase the risk of moral hazard. The presence of flexible compliance and relational monitoring suggests that governance practices are not fully institutionalized, thereby creating space for discretionary behavior among customers. Moreover, socio-cultural proximity, while beneficial for building rapport, may blur professional boundaries and reduce the effectiveness of risk management practices. Therefore, these findings highlight the need for Islamic banks to strike a balance between relational engagement and formal governance in order to maintain both customer trust and institutional accountability in *mudharabah* financing.

### 3.4. The Impact of Moral Hazard

The findings indicate that moral hazard practices in *mudharabah* financing at Bank Syariah Indonesia, Palopo Branch, generate significant impacts on both institutional performance and the effectiveness of profit-sharing mechanisms. Based on field evidence, moral hazard behaviors such as profit underreporting and misuse of funds directly affect the accuracy of profit-sharing calculations, leading to financial losses for the bank. In addition, these practices reduce the overall efficiency of *mudharabah* financing, as the bank faces increased uncertainty and risk in managing its financing portfolio. The findings also reveal that persistent moral hazard contributes to declining trust between the bank and customers, which may ultimately influence the bank’s strategic decision to limit the use of profit-sharing contracts in favor of less risky financing schemes. Furthermore, these conditions may undermine the fundamental principles of fairness and transparency that underpin Islamic banking practices.

The findings show that moral hazard has significant implications for the effectiveness of *mudharabah* financing. These include financial losses, inefficiencies in profit-sharing calculations, declining trust, and a shift toward less risky financing schemes.

One bank officer stated:

*“Kadang hasil yang dilaporkan tidak sesuai, sehingga kami kesulitan menghitung bagi hasil yang akurat.”* (A01)

Another informant explained:

*“Risiko seperti ini membuat bank lebih berhati-hati, bahkan cenderung mengurangi pembiayaan mudharabah.”* (A02)

These impacts indicate that moral hazard affects not only financial outcomes but also institutional strategies.

**Table 4. Impacts of Moral Hazard in Mudharabah Financing at Bank Syariah Indonesia**

No	Impact	Description of Findings	Field Evidence
1	Financial Losses	Inaccurate profit-sharing due to underreported income	Gap between expected and actual returns
2	Inefficiency of Financing	Increased uncertainty in managing financing performance	Difficulty in assessing true business outcomes
3	Declining Trust	Reduced confidence between bank and customers	Increased skepticism in customer reporting
4	Shift in Financing Strategy	Preference for lower-risk contracts (e.g., non-profit-sharing)	Reduced proportion of <i>mudharabah</i> financing
5	Weakening of Sharia Principles	Erosion of fairness and transparency in contracts	Deviation from ideal profit-sharing principles

*Source: Research result*

The impacts identified in this study demonstrate that moral hazard in *mudharabah* financing has far-reaching consequences beyond individual transactions, affecting the broader sustainability of Islamic banking practices. From the perspective of Agency Theory, these impacts reflect the failure to align incentives between the principal (bank) and the agent (customer), resulting in inefficiencies and increased monitoring costs. Financial losses and inefficiencies indicate that information asymmetry is not effectively managed, while declining trust highlights the erosion of relational capital that is essential in profit-sharing contracts. Moreover, the observed shift toward less risky financing schemes suggests a structural response by the bank to mitigate risk, which may inadvertently reduce the distinctiveness of Islamic banking models. The weakening of Sharia principles further emphasizes that moral hazard is not only an economic issue but also a normative concern, as it challenges the ethical foundation of Islamic finance. Therefore, these findings underscore the urgent need for more robust governance mechanisms that can simultaneously address economic efficiency and ethical compliance in *mudharabah* financing.

### 3.5. Mitigation Strategy from Bank

The findings reveal that Bank Syariah Indonesia, Palopo Branch, has implemented several strategies to mitigate moral hazard risks in *mudharabah* financing. These strategies are primarily focused on strengthening monitoring mechanisms, improving customer selection processes, and enhancing communication between the bank and customers. In practice, the bank conducts periodic monitoring through business visits and requires regular financial reporting from customers. Additionally, stricter screening procedures are applied during the financing approval stage to assess the credibility and business feasibility of prospective customers. The findings also indicate that the bank emphasizes a relational approach by maintaining close communication with customers to foster trust and encourage transparency. However, despite these efforts, certain limitations persist, particularly in ensuring the consistency of monitoring and the accuracy of self-reported financial data, which continue to pose challenges in fully mitigating moral hazard.

The bank has implemented several strategies to mitigate moral hazard, including periodic monitoring, stricter customer screening, and maintaining close communication with customers. However, these strategies face practical limitations, particularly in ensuring consistent supervision.

As stated by a bank officer:

*“Kami melakukan kunjungan usaha, tapi memang tidak bisa terlalu sering karena keterbatasan waktu dan sumber daya.” (A01)*

Another informant added:

*“Kami juga menilai karakter nasabah sejak awal, karena itu sangat menentukan.” (A03)*

These findings suggest that while mitigation efforts exist, they are not yet fully effective in addressing moral hazard risks.

**Table 5. Mitigation Strategies for Moral Hazard in Mudharabah Financing at Bank Syariah Indonesia**

No	Mitigation Strategy	Description of Implementation	Field Evidence
1	Periodic Monitoring	Regular business visits and evaluation of customer performance	Scheduled but not always intensive monitoring
2	Financial Reporting Requirements	Customers required to submit periodic financial reports	Reliance on self-reported data
3	Customer Screening	Strict selection based on business feasibility and character assessment	Use of background checks and feasibility analysis
4	Relationship-Based Approach	Maintaining close communication with customers	Frequent informal interactions
5	Risk Diversification	Limiting exposure to <i>mudharabah</i> financing	Preference for less risky financing schemes

*Source: Research result*

The mitigation strategies implemented by the bank demonstrate a combination of formal control mechanisms and relational approaches in addressing moral hazard risks. From the perspective of Agency Theory, these strategies aim to reduce information asymmetry and align the interests of the principal (bank) and the agent (customer). Periodic monitoring and financial reporting requirements represent formal efforts to improve transparency and accountability, while customer screening seeks to minimize adverse selection at the initial stage of financing. However, the continued reliance on self-reported data indicates that information asymmetry remains a critical challenge. Furthermore, the relational approach, while effective in building trust, may inadvertently weaken the rigor of formal control mechanisms if not properly balanced. The strategy of risk

diversification, reflected in the reduced reliance on *mudharabah* financing, suggests a defensive institutional response to persistent moral hazard risks. Therefore, these findings highlight that while existing mitigation strategies are partially effective, a more integrated approach—combining technological monitoring systems, enhanced financial literacy, and stricter governance frameworks—is necessary to more effectively address moral hazard in Islamic banking practices.

### 3.6. Model / Pattern of Findings

The overall findings of this study reveal a systematic pattern of moral hazard in *mudharabah* financing at Bank Syariah Indonesia, Palopo Branch, which can be conceptualized as an interconnected process involving antecedents, behavioral manifestations, and resulting impacts. The analysis indicates that structural and contextual factors—such as information asymmetry, limited monitoring, and socio-cultural proximity—serve as key antecedents that shape customer behavior. These conditions subsequently give rise to various forms of moral hazard, including profit underreporting, financial manipulation, and misuse of funds. The interaction between these factors is further reinforced by relational dynamics between the bank and customers, which, while fostering trust, may also weaken formal control mechanisms. As a result, these behaviors generate adverse impacts, such as financial inefficiencies, declining trust, and a shift in financing strategies. This pattern reflects a cyclical and reinforcing mechanism, where unresolved structural issues continue to reproduce moral hazard practices over time.

The overall findings reveal a systematic pattern of moral hazard that involves interconnected elements: antecedents, behavioral forms, relational dynamics, and impacts. Structural factors such as information asymmetry and limited monitoring create conditions for opportunistic behavior, which is reinforced by trust-based relationships and leads to significant institutional impacts.

This pattern is reflected in the following statement:

*“Kalau pengawasan kurang, ya kemungkinan penyimpangan pasti ada, apalagi kalau sudah terlalu percaya.”* (A02)

Another informant emphasized:

*“Sebenarnya bukan hanya soal niat, tapi juga karena sistemnya belum terlalu kuat.”* (C4)

These findings confirm that moral hazard is a systemic issue shaped by the interaction of structural, behavioral, and relational factors.

**Table 6. Model of Moral Hazard Patterns in Mudharabah Financing at Bank Syariah Indonesia**

No	Model Components	Key Elements	Description of Relationship
1	Antecedents	Information asymmetry, limited monitoring, socio-cultural proximity	Structural and contextual factors that enable moral hazard

2	Behavioral Forms	Underreporting, financial manipulation, misuse of funds	Manifestations of opportunistic behavior by customers
3	Relational Dynamics	Trust-based interaction, flexible compliance	Social interactions that influence control mechanisms
4	Impacts	Financial losses, inefficiency, declining trust, strategic shift	Consequences affecting bank performance and governance
5	Feedback Loop	Weak governance reinforcement	Unresolved issues reproduce moral hazard over time

Source: Research result

The model presented in Table X illustrates that moral hazard in *mudharabah* financing operates as a dynamic and interrelated system rather than a linear phenomenon. From the perspective of Agency Theory, the antecedent factors represent the structural conditions that intensify the principal-agent problem, particularly through information asymmetry and limited monitoring capacity. These conditions create an environment in which opportunistic behaviors can emerge and persist. The inclusion of relational dynamics highlights an important contextual dimension, demonstrating that social proximity and trust-based interactions may simultaneously facilitate cooperation and weaken formal governance. Furthermore, the identified impacts indicate that moral hazard not only affects financial outcomes but also shapes institutional strategies, such as the reduced reliance on profit-sharing contracts. The presence of a feedback loop suggests that without effective intervention, these patterns are likely to be continuously reproduced. Therefore, this model provides a comprehensive framework for understanding the complexity of moral hazard in Islamic banking and offers a foundation for developing more integrated and sustainable mitigation strategies.

#### 4. DISCUSSION

The findings of this study indicate that moral hazard practices in *mudharabah* financing at Bank Syariah Indonesia in Palopo do not occur randomly, but rather represent a logical consequence of the interaction between structural, behavioral, and socio-contextual factors. The dominance of practices such as profit underreporting, financial statement manipulation, and misuse of funds can be effectively explained through the lens of Agency Theory, which posits that the relationship between principals and agents inherently involves conflicts of interest, particularly under conditions of information asymmetry. In the context of *mudharabah*, customers as agents possess superior knowledge regarding business performance, enabling them to engage in

opportunistic behavior aimed at maximizing personal gains while minimizing profit-sharing obligations to the bank. This finding is consistent with prior studies in Islamic Finance, which highlight that profit-sharing contracts tend to carry higher moral hazard risks compared to debt-based financing due to limited direct control by financial institutions (Halkos, 2023).

Furthermore, the limited monitoring capacity of the bank and the weak financial reporting systems among micro, small, and medium enterprises (MSMEs) further reinforce the emergence of such practices. This study confirms that in business environments characterized by low levels of formalization, as commonly found in Palopo, non-standardized financial record-keeping creates opportunities for data manipulation and a lack of transparency. These findings are in line with previous research emphasizing that low financial literacy and weak governance structures are key determinants of moral hazard in Islamic financing. In addition, the socio-cultural dimension, reflected in the close relationships between bank officers and customers, presents a dual effect. On one hand, trust-based interactions facilitate smoother communication and strengthen partnerships; on the other hand, they may weaken formal control mechanisms and increase tolerance toward deviations. This suggests that moral hazard is not solely driven by rational economic incentives but is also shaped by social norms and relational dynamics embedded in the local context (Danlami & Danlami, 2024).

The impacts identified in this study, including financial losses, inefficiencies in financing, and a strategic shift toward less risky financing instruments, indicate broader systemic implications for the sustainability of mudharabah contracts. These findings support the argument in the literature that the inability to effectively manage moral hazard risks may reduce the competitiveness of profit-sharing financing and push Islamic banks toward instruments that resemble conventional financing models. Although the mitigation strategies implemented by the bank—such as enhanced monitoring, stricter customer screening, and relational engagement—reflect efforts to reduce information asymmetry and strengthen control, this study finds that these measures remain only partially effective. Therefore, a more comprehensive and integrated approach is required, encompassing not only improved monitoring systems but also enhanced financial literacy, strengthened reporting mechanisms, and context-sensitive governance frameworks. Such an approach is essential to ensure that mudharabah financing operates more effectively in accordance with the principles of fairness and transparency that underpin Islamic finance (Danlami & Danlami, 2024; Halkos, 2023; Sodik et al., 2023).

## 5. CONCLUSION

This study concludes that moral hazard practices in mudharabah financing at Bank Syariah Indonesia in Palopo represent a complex and systemic phenomenon shaped not only by information asymmetry but also by limited monitoring mechanisms, low levels of customer financial literacy, and the strong influence of socio-cultural dynamics in bank–customer relationships. A particularly noteworthy finding is that trust-based relationships—originally intended to strengthen Islamic financial principles—may, in practice, create vulnerabilities by weakening formal control mechanisms and enabling opportunistic behaviors such as profit underreporting, financial manipulation, and misuse of funds. This pattern suggests that moral hazard in mudharabah financing is not an isolated issue but rather the result of dynamic interactions among structural, behavioral, and relational factors that reinforce one another.

Based on these findings, important policy implications emerge for strengthening the governance of profit-sharing financing. Islamic banks, particularly Bank Syariah Indonesia, need to enhance monitoring systems by leveraging digital technologies to reduce reliance on self-reported customer data, while also improving customer screening and evaluation processes. Furthermore, increasing financial literacy and customer understanding of mudharabah principles is essential to minimize misinterpretation and reduce deviant behavior. While relational approaches should be maintained to foster trust and engagement, they must be balanced with stronger formal control mechanisms to ensure accountability and consistency in financing practices.

For future research, it is recommended to expand the scope of analysis by employing quantitative or mixed-method approaches in order to measure the influence of each determinant of moral hazard more rigorously and enhance the generalizability of findings. Comparative studies across regions or Islamic financial institutions are also encouraged to capture variations in practices and the effectiveness of mitigation strategies. Additionally, future studies may explore the role of financial technology (fintech) in improving transparency and accountability in mudharabah financing. Such research directions are expected to contribute to a more comprehensive understanding and to support the development of more sustainable and integrity-driven Islamic financial practices.

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