



Three-Layer Integrative Risk Mitigation: A Model of Islamic Financing Risk Management in Indonesia

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Abstract

The rapid growth of the Islamic banking industry in Indonesia presents a unique risk landscape, particularly the risk of Sharia non-compliance and yield risk, which are fundamentally different from conventional banking. There is a significant gap between the theoretical frameworks Agency Theory, Risk Theory, and Sharia Compliance Theory and their integrated implementation in operational practice, thus requiring a holistic risk management model. Therefore, this study aims to analyze existing risk management practices and subsequently formulate a comprehensive and contextualized Islamic financing risk mitigation model for Indonesia. Using a qualitative approach, data were collected through in-depth interviews and document analysis from three Islamic commercial banks in Indonesia, then analyzed using an interactive model. Key findings reveal that practitioners manage the duality of commercial and sharia risks through a three-layer integrative risk mitigation model that emerged from field practice. This model consists of: (1) a Sharia Compliance Fortress foundation overseen by the Sharia Supervisory Board; (2) an Institutional Risk Management layer that adapts conventional tools; and (3) a Contract-Specific Risk Management layer to address agency issues such as information asymmetry and moral hazard. The dominance of debt-based contracts is identified as a pragmatic strategy to mitigate the more complex risks of profit-sharing schemes. This study makes a conceptual contribution by proposing a model that aligns these three theoretical pillars within a single operational architecture. Practically, this model offers a strategic framework for practitioners, regulators, and academics to strengthen the effectiveness of risk management while maintaining sharia integrity.

Keywords: sharia financing, risk management, risk mitigation.

1. Introduction

The global Islamic finance industry has demonstrated resilience and consistent growth, even amidst global economic uncertainty (Tsiotas, 2022). Indonesia, as the country with the largest Muslim population in the world, represents a very significant market and is a key driver of this ecosystem. Data from the Financial Services Authority (OJK) shows a solid year-over-year growth trend in Islamic banking assets. In August 2024, total Islamic financial assets in Indonesia reached IDR 2,742 trillion (approximately USD 152.4 billion), marking a 13% year-on-year increase, with Islamic banking assets contributing IDR 980.3 trillion. This growth is driven not only by increased public awareness of Sharia-based financial products and services, but also by strong regulatory support from the government, as stipulated in Law No. 21 of 2008 concerning Sharia Banking and various accompanying OJK regulations. However, behind the impressive growth figures, Sharia banking harbors unique characteristics and complex risks, fundamentally different from conventional banking (Qin et al., 2021). These differences stem from the fundamental principles of Sharia, which prohibit *riba* (interest), *gharar* (excessive uncertainty), and *maysir* (speculation), as well as requiring transactions to be based on real assets (asset-based/asset-backed) and a profit-and-loss sharing scheme (PLS). Consequently, Islamic financing products such as *Murabahah* (buying and selling with profit margin), *Musarakah* (partnership), *Mudharabah* (profit sharing), and *Ijarah* (rental) give rise to risk profiles that cannot be analyzed and mitigated using only conventional risk management frameworks.

The central phenomenon focused on in this research is the unique risks inherent in Islamic financing, which require a specific and effective risk management and mitigation model. These risks encompass not only those commonly recognized in the banking industry, such as credit, market,

liquidity, and operational risks, but also unique risks (Dalhatu & Sharofiddin, 2021). One of the most prominent risks is sharia non-compliance risk. This risk arises when a bank's products, operations, or practices do not align with the fatwas of the National Sharia Council (DSN-MUI) and applicable sharia principles. Failure to maintain sharia compliance not only results in regulatory sanctions but can also erode customer and investor trust, ultimately triggering serious reputational and liquidity risks. In addition, the profit-sharing scheme in Mudharabah and Musyarakah contracts gives rise to rate of return risk and equity investment risk, where the bank acts as an investor or partner and shares the risk of business losses with the customer (Hanley, 2017), an exposure that differs significantly from the creditor-debtor model in conventional banks (Angiuli et al., 2022) (Chiu & Kalabić, 2021).

The significance of this issue becomes increasingly crucial given the ever-evolving landscape of the financial industry, including in the digital era. Digital transformation, on the one hand, opens up opportunities for efficiency and broader market reach, but on the other hand, gives rise to new challenges such as cyber risks and the need for technological adaptation in line with sharia principles (Neupane et al., 2023) ((Rajasekharaiah et al., 2020) (Li et al., 2025). Therefore, the development of a comprehensive risk management model, capable of integrating the entire spectrum of risks—both conventional and unique—is a necessity for the sustainability and stability of the Islamic banking industry in Indonesia. This research has high academic and social relevance because it seeks to fill the gap in the literature regarding a holistic and practically implementable risk mitigation model, as well as contributing to regulators and practitioners in strengthening the resilience of national Islamic banking.

The study of risk management in Islamic banking has received significant attention in the academic literature over the past decade. Various studies have identified and categorized the types of risks faced by Islamic banks. In general, these risks can be classified into two broad categories: (1) risks similar to those faced by conventional banks (credit, market, liquidity, operational, legal, and strategic risks), and (2) unique risks arising from adherence to Islamic principles (Islamic non-compliance risk, yield risk, and displaced commercial risk).

Recent studies emphasize that although Islamic and conventional banks share some types of risks, their sources and impacts can be quite different. (Fatihin et al., 2024) found that financing risk is the most significant risk affecting the performance of Islamic banks in Indonesia, followed by market, liquidity, and yield risks. This underscores the importance of specific mitigation techniques for each type of financing contract. For example, credit risk in Murabahah financing centers on the customer's repayment capacity, while in Musyarakah, the risk is more complex because it involves the operational performance of the partner's business. Research by (Karimah, 2022a) highlights the duality of risks: legal risk (related to the national legal system) and sharia risk (related to compliance with Islamic principles), which requires mitigation strategies through strengthening shariah governance.

Within the context of theoretical frameworks, Agency Theory is often used to explain the relationships and potential conflicts of interest within the governance structure of Islamic banks. Unlike conventional banks, where the primary agency relationship is between shareholders (principals) and management (agents), Islamic banks have a more complex agency structure. An additional agency relationship exists between depositors/investment account holders (as principals) and the bank (as agent/mudharib), where the bank is mandated to manage funds in accordance with Islamic principles. Furthermore, the existence of the Sharia Supervisory Board (SSB) as an additional layer of oversight creates a unique agency dynamic between the SSB, the board of directors, and shareholders. Several studies have shown that strong governance mechanisms, such as board independence and SSB competence, can reduce agency costs and mitigate risks, including the risk of Islamic non-compliance.

Furthermore, Risk Theory in the context of Islamic finance emphasizes that risk should not be completely avoided, but rather managed (risk management) through risk sharing. This principle is most clearly manifested in profit-sharing contracts. However, in practice, numerous studies have identified that Islamic bank financing portfolios in Indonesia and many other countries are still dominated by debt-based contracts, such as Murabahah, which tend to be risk-transferring rather than risk-sharing. This phenomenon indicates a shift from the ideal model of Islamic finance, often driven by the need to compete with conventional banks and the perceived higher risk of profit-sharing schemes.

Finally, Sharia Compliance Theory serves as a fundamental foundation that distinguishes Islamic banks. Sharia compliance is not only about fulfilling formal legal requirements, but also concerns the substance and objectives of Sharia (maqasid sharia). A study by Usdeldi et al. (2022) emphasized that

Sharia compliance is a manifestation of fulfilling all the principles required of Islamic institutions. However, its implementation in the field faces challenges, as noted by Waluyo (2016), who found that the commitment to comply with the DSN fatwa is not yet fully effective and efficient, and the role of the DPS is not yet optimal.

The current state of the art of research indicates that although numerous studies have identified risks and discussed theoretical frameworks separately, significant gaps remain. Table 1 below summarizes some relevant research from the past five years that highlights various aspects of risk management in Islamic banking.

Researcher (Year)	Research Focus	Key Findings	Limitations / Gaps
(Fatihin et al., 2024)	The impact of risk management on the performance of Islamic banks in Indonesia	Financing risk is the most influential, followed by market, liquidity and yield risks.	Not yet formulated a specific mitigation model for each type of risk.
(Karimah, 2022b)	Analysis of legal and sharia risks and the role of sharia governance	Islamic banks face dual risks that require strengthening the role of DPS and contract standardization.	Focus on legal and governance aspects, less in-depth integration with risk and agency theory.
(Naim, 2022)	The effect of board size and agency costs on bank performance	A larger board size can increase oversight and reduce agency costs.	Does not explicitly link agency costs to a specific financing risk management model.
(Ayunungtyas et al., 2022)	Good corporate governance and capital structure	Risk mediates the relationship between Islamic financing structure and financial performance.	Using quantitative data and not yet exploring the implementation process at a practical level.
(Abbas et al., 2020)	An empirical exploration of Islamic banking business income in Indonesia	Finding challenges in optimizing revenue from sharia products.	Lack of linking revenue challenges to weaknesses in existing risk management models.

Table 1. Summary of Recent Literature on Islamic Banking Risk Management

From the above review, a clear research gap has been identified. First, there is a disconnect between theoretical discussion and practical implementation. Many studies discuss Agency Theory, Risk Theory, and Sharia Compliance Theory normatively and separately, but few have qualitatively explored in depth how these three theories clash or can be integrated at the operational level of Islamic banks in Indonesia. Second, although numerous studies have identified various risks, there has been no comprehensive effort to formulate a holistic risk mitigation model specifically designed to address the unique characteristics of Islamic financing by simultaneously considering both agency dynamics and Sharia compliance imperatives. Existing models are often adaptations of conventional frameworks (such as the Basel Framework) with some adjustments, but they fail to fully capture the essence of risk in Islamic contracts.

Therefore, this research aims to bridge this gap. Using a qualitative case study approach, this research will delve deeper into how practitioners in Indonesian Islamic banking understand, manage, and attempt to reconcile the tensions arising from these three theoretical frameworks in their daily risk management practices. Based on the background and research gaps outlined, this study aims to:

1. Analyze and deeply understand the Islamic financing risk management model currently implemented by Islamic banks in Indonesia, with a focus on how practitioners navigate the intersection of agency theory, risk theory, and Islamic compliance theory.
2. Formulate a comprehensive and contextual Islamic financing risk mitigation model for banking in Indonesia, explicitly integrating the principles of these three theories to enhance effectiveness and Islamic compliance.

This research uses literature review builds on three fundamental theoretical pillars that collectively shape the risk management landscape in Islamic banking: Agency Theory, Risk Theory, and Sharia Compliance Theory. An analysis of the current literature demonstrates that, although often

discussed separately, a comprehensive understanding of the phenomenon of Islamic financing risk management can only be achieved through a critical synthesis of these three theories.

Agency Theory in the Context of Islamic Banking Dualism

Agency Theory, popularized by Jensen and Meckling (1976), fundamentally addresses the problems arising from the delegation of authority from a principal to an agent. This issue, known as the agency problem, arises from potential conflicts of interest and information asymmetry between the two parties, ultimately giving rise to agency costs for monitoring and control. In the context of conventional banking, the primary agency relationship exists between shareholders (principals) and management (agents). However, the Islamic banking structure presents a much greater layer of complexity, creating a unique and multi-layered network of agency relationships.

Academic literature consistently highlights at least three levels of agency relationships in Islamic banks. First, the classic relationship between shareholders and management remains, where management is expected to maximize shareholder wealth. Second, and most distinctively, is the relationship between Investment Account Holders (IAH) as fund providers (*shahibul maal*) and Islamic banks acting as investment managers (*mudharib*). In this relationship, the bank (agent) has a significant information advantage over the IAH (principal) regarding actual investment performance, thus giving rise to the potential for moral hazard and adverse selection (Taswan, R. Ibrahim, 2020). Banks may be tempted to take risks that are inconsistent with the IAH's expectations or be less transparent in reporting investment returns.

Third, the existence of the Sharia Supervisory Board (SSB) as a sharia governance mechanism creates additional agency dynamics. The SSB acts as an agent for stakeholders (including customers and regulators) to ensure that management adheres to sharia principles. However, the SSB itself can face conflicts of interest, particularly regarding their independence and the compensation they receive from the banks they supervise (Basiruddin & Ahmed, n.d.). A qualitative study by Taswan, R. Ibrahim, 2020, in Malaysia found that Islamic bank management often views their relationship with the Islamic Sharia Supervisory Board (IAH) as more of a fiduciary relationship than a pure agency relationship, yet the challenge of balancing the interests of the Islamic Sharia Supervisory Board (IAH) and shareholders remains a central issue. In Indonesia, research by Rahmat, 2016, suggests that effective board governance mechanisms, including the role of the SSB, can be key to reducing agency costs. However, their quantitative research has not delved deeply into how risk managers practically navigate this dilemma in day-to-day financing decision-making.

The relevance of agency theory to this research lies in its ability to frame potential conflicts of interest inherent in the operational structure of Islamic banks. These conflicts directly impact risk exposure. For example, pressure from shareholders to achieve high profitability (agency problem 1) may encourage management to prefer more predictable debt-based financing contracts such as *Murabahah* over riskier profit-sharing contracts, even though profit-sharing contracts are more in line with Islamic financial philosophy. This creates a tension that will be further explored in this research.

Risk Theory: Shifting from Risk Sharing to Risk Transfer

Risk theory in Islamic finance has a philosophically distinct premise from conventional finance. While conventional finance focuses on risk transfer through interest-based instruments and collateral, Islamic finance advocates risk sharing as a manifestation of fairness and partnership. This principle is most clearly reflected in equity-based contracts such as *Musharakah* (partnership) and *Mudharabah* (profit-sharing), where profits and losses are shared between the bank and the client managing the business. This ideal framework implies that risk should not be avoided but rather managed collaboratively.

However, empirical studies consistently demonstrate a significant gap between theoretical idealism and practical reality. Islamic banking financing portfolios in Indonesia, as in many other countries, are heavily dominated by debt-based contracts such as *Murabahah* (margin-based sale and purchase), *Ijarah* (leasing), and *Salam/Istisna* (order-based sale and purchase) (Ihyak & Suprayitno, 2023a). These contracts, while valid under Sharia law, inherently involve risk transfer rather than risk sharing (Lajis, 2019). Banks transfer business risks to customers and position themselves more as creditors than partners. This phenomenon, often referred to as the “*Murabahah syndrome*,” is driven by several factors, including competitive pressures from conventional banks, a more accommodating regulatory framework for debt-based contracts, and the perception that profit-sharing financing carries higher risks and is more difficult to manage (Rustam, 2024).

This shift in practices creates unique risks. A study in Indonesia (Fatihin et al., 2024) confirmed that financing risk (mostly non-profit-sharing based) is the most significant risk affecting Islamic bank performance. Furthermore, Islamic banks face rate of return risk and displaced commercial risk. This risk arises when banks feel pressured to provide competitive returns to depositors (IAH), even when the underlying asset performance of the profit-sharing financing is inadequate. As a result, banks may divert some of their shareholder profits to cover the shortfall in returns to depositors, in order to maintain their reputation and prevent mass withdrawals (Nelly et al., 2022).

In-depth qualitative studies on how risk managers navigate the dilemma between the idealism of risk sharing and the pragmatism of risk transfer are still limited. Many studies, such as those by (Fatihin et al., 2024) and (Suparmin, 2019), use quantitative approaches to measure risk impact, but have not explored the decision-making processes, considerations, and justifications used by practitioners in the field when selecting financing contract structures. This study aims to fill this gap by exploring practitioners' experiences in managing financing portfolios that lie at the intersection of these two distinct risk philosophies.

Sharia Compliance Theory as a Foundation and Source of Risk

Sharia Compliance Theory is the most fundamental pillar that distinguishes Islamic financial institutions from conventional entities. This compliance goes beyond merely fulfilling the legal and formal aspects of fatwas issued by the National Sharia Council (DSN-MUI) in Indonesia, but also encompasses the fulfillment of the substance and noble objectives of Sharia (maqasid al-shariah), such as justice, welfare, and the avoidance of exploitation (Ihyak & Suprayitno, 2023b). Sharia compliance is the *raison d'être* of Islamic banking and a primary source of customer trust.

Paradoxically, this fundamental pillar also poses a significant risk, namely the risk of sharia non-compliance. This risk is defined as the risk of loss arising from a bank's failure to comply with sharia principles as stipulated in the DSN-MUI fatwa and other sharia standards. This failure can occur at various levels: from product design and documentation and contract processes to day-to-day operations. The consequences of this risk are severe, not only in the form of sanctions from regulators (the Financial Services Authority), but more crucially, the potential loss of public and investor trust, which can trigger a fatal reputational and liquidity crisis (Ramdani & Kamal, 2023).

Studies in Indonesia highlight the challenges in implementing Sharia compliance. Karimah (2022) identified a dual risk landscape: legal risk (related to the national legal system) and Sharia risk, which often require separate but integrated management through strengthening Sharia governance. Research by Waluyo (2016) several years ago found that the commitment to comply with the National Sharia Supervisory Board (DSN) fatwas was not yet fully effective and the role of the Sharia Supervisory Board (SSB) was not yet optimal, findings that remain relevant in current discussions (Asni* et al., 2019) (M. Ibrahim et al., 2021). A more recent study by Ramdani & Kamal (2023), examining Sharia banks in Indonesia, found that good corporate governance mechanisms can mitigate the risk of Sharia non-compliance. However, these studies tend to focus on governance aspects and quantitative measurements, and do not explore how this Sharia compliance dilemma is negotiated in financing risk management practices. For example, how does a risk manager balance the demands of speed in the financing process (operational efficiency) with the need to ensure that every clause in the Murabahah contract perfectly fulfills its pillars and conditions?

Interrelationships and Tensions Between Theories in Practice

The literature analysis above shows that these three theories do not operate in a vacuum. In the operational practice of Islamic banking in Indonesia, they are interrelated and often create complex tensions.

1. Tension between Agency Theory and Sharia Compliance Theory: Agency conflicts between management and shareholders can encourage management to pursue profit targets in ways that may fall within a "grey area" from a Sharia compliance perspective. For example, to expedite the disbursement of Murabahah financing, the bank may not strictly verify the existence and ownership of goods, potentially violating Sharia principles. Here, the agent's interests (short-term profit) directly conflict with the Sharia compliance imperative.
2. Tension between Risk Theory and Sharia Compliance Theory: The industry's preference for risk-transfer contracts (such as Murabahah) which are considered safer and easier to standardize (from the Risk Theory perspective) often overrides risk-sharing contracts (Musyarakah and Mudharabah). Although not a legal-formal violation of Sharia compliance, this practice is debated by some academics because it is considered less reflective of the spirit and maqasid al-

Shariah, which emphasize partnership and justice (from the Sharia Compliance Theory perspective).

3. Tension between Agency Theory and Risk Theory: In an agency relationship between a bank (mudharib) and a depositor (shahibul maal), the bank may exhibit risk aversion. The bank as an agent may prefer to channel depositors' funds into safer instruments (e.g., Murabahah for the consumer sector) to protect its own reputation and profitability, even though the depositor (principal) may have a higher risk tolerance and expect greater returns from equity-based financing to the productive sector.

2. Methods

This research employed a qualitative approach with a multiple case study design. A qualitative approach was chosen for its ability to explore and understand phenomena in depth and holistically within their natural context (Creswell & Poth, 2018). Given that the research objective was to understand how Islamic banking practitioners interpret, manage, and integrate various theoretical frameworks (agency, risk, and Sharia compliance) in daily practice, this approach was deemed most relevant. The phenomenon of Islamic financing risk management is complex, context-laden, and involves human perceptions and experiences that cannot be measured quantitatively.

A multiple case study design was chosen to allow researchers to conduct in-depth exploration of multiple units of analysis (cases) simultaneously (Yin, 2018). By studying several Islamic banks as separate cases, this study was able to identify patterns unique to each case as well as cross-case patterns. The use of this design will strengthen the external validity and level of analytical generalization of the research findings, as conclusions are drawn not only from a single context but also from logical comparison and replication across multiple contexts (Yin, 2018).

This research was conducted in the context of the Islamic banking industry in Indonesia. Indonesia was chosen as the research setting due to its position as the country with the largest Muslim population in the world and a rapidly growing Islamic financial market, yet it also faces unique risk challenges. The unit of analysis in this study is the financing risk management practices of three Islamic Commercial Banks (BUS) in Indonesia.

The selection of informants and banks as cases used a purposive sampling technique. This technique allows researchers to select informants with the most relevant knowledge, experience, and positions to provide in-depth insights into the research topic (Palinkas et al., 2015). The criteria for selecting banks as cases were:

1. Sharia Commercial Banks (BUS) that have been operating in Indonesia for at least 10 years.
2. Have a diversified financing portfolio (covering murabahah, mudharabah, and musyarakah contracts).
3. Represent different asset classes (e.g., one large-scale bank, one medium-scale bank, and one small-scale bank) to capture variations in practices.

Informants will be selected from various hierarchical levels within the banks to gain a comprehensive perspective, including:

1. Strategic Level: Directors in charge of risk management or financing functions.
2. Managerial Level: Head of Risk Management Division and Head of Sharia Financing Division.
3. Supervisory Level: Members of the Sharia Supervisory Board (SSB).
4. Operational Level: Risk managers or senior financing analysts.

The total number of informants involved will range from 12 to 15.

To obtain a rich and in-depth understanding, this study implemented a data triangulation strategy using several data collection techniques, namely:

1. In-depth Interviews: As the primary data source, semi-structured interviews will be conducted with selected informants. An interview guide will be developed based on the theoretical framework and research objectives, while still allowing the researcher the flexibility to ask follow-up questions to explore deeper information. Interviews will be recorded using an audio recorder with the informant's consent and subsequently transcribed verbatim.
2. Document Analysis: Secondary data will be collected through the analysis of internal and external company documents. Documents analyzed include: annual reports, corporate governance reports (GCG reports), financing risk management policy documents and standard operating procedures (SOPs), DSN-MUI fatwas related to financing products, and relevant Financial Services Authority (OJK) regulations.

3. Literature Review: An ongoing literature review will be conducted of journal articles, books, and previous research reports to enrich the analysis and compare the research findings with existing knowledge.

Data Analysis

The data analysis in this study will follow the interactive analysis model developed by Miles et al., 2014. This model consists of three simultaneous and iterative activity streams: data condensation, data presentation, and drawing/verifying conclusions.

1. Data Condensation: This process refers to the selection, focusing, simplifying, and abstracting of data emerging from interview transcripts and field notes. At this stage, researchers will code both descriptive and inferential codes to identify significant data segments relevant to the research question.
2. Data Display: After the data has been condensed, the next step is to present the information in an organized and concise format, such as a matrix, flowchart, or table.
3. Conclusion Drawing/Verification: From the beginning of the research, researchers begin drawing tentative conclusions. These conclusions are then continuously tested and verified throughout the research process. Researchers will seek meaning from emerging patterns, note regularities, and develop theoretical propositions that are strongly supported by the data.

This analysis process will be assisted by Computer-Assisted Qualitative Data Analysis Software (CAQDAS) such as NVivo or ATLAS.ti to facilitate the management and coding of large data sets. **Table 2** below provides a simple example of how the data analysis process might work.

Raw Data Excerpt (Interview)	Initial Code (Condensation)	Evolving Themes	Relation to Theory
"The biggest risk in musharaka is not the customers, but their honesty. As a bank, we can't monitor their operations 24/7. There's the potential for moral hazard, as they report lower profits than actual ones."	- Risk of partner honesty - Moral hazard - Limited supervision	The Challenge of Information Asymmetry in Profit Sharing Contracts	Agency Theory
"Every new product must pass a DPS review. We don't want any OJK findings or public rumors that our products are non-Sharia-compliant. Reputation is everything for a Sharia bank."	- The central role of the DPS - Fatwa compliance - Reputational risk - Avoiding sanctions	Sharia Compliance Imperative as Reputational Risk Mitigation	Sharia Compliance Theory

Table 2. Example of Thematic Data Analysis Flow

To ensure the quality and trustworthiness of qualitative research results, researchers will implement several strategies adapted from the framework (Lincoln et al., 1985):

1. Credibility: To ensure that the research findings align with the reality being studied, data source triangulation (comparing data from interviews, documents, and literature) and member checking (presenting initial findings to several informants for confirmation and input) will be conducted.
2. Transferability: The researcher will present an in-depth description of the research context, the characteristics of the bank and participants, and the data collection and analysis process. This allows readers to assess the extent to which these findings can be applied to other similar contexts.
3. Dependability: To demonstrate the consistency and stability of the research process, an audit trail will be created. This trail includes detailed documentation of each step taken, from problem formulation and informant selection, interview transcripts, to analytical notes and decision-making.
4. Confirmability: This strategy ensures that the research findings are derived from the data, not from the researcher's bias or imagination. Confirmability is achieved through triangulation practices and maintaining an audit trail that can be verified by an independent party.

3. Results and Discussion

An in-depth analysis of data collected from interviews, observations, and documents at the three Islamic banks subject to this study yielded a series of key findings. These findings are presented thematically to address the research objectives, namely to analyze existing risk management models and formulate a more comprehensive mitigation framework. The data presented below reflects the perspectives of practitioners from various levels—strategic, managerial, supervisory, and operational—and collectively form a comprehensive picture of Islamic financing risk management practices in Indonesia.

The Perception of Duality of Risk: Commercial vs. Sharia Compliance

The first finding that emerged consistently across all cases was the perception that risk in Islamic banking has two inseparable dimensions: commercial and Sharia compliance. Informants viewed risk not only as the potential for financial loss (credit, market, and operational risk), but also as the potential for violations of Sharia principles that could undermine the foundation of the bank's existence.

A Risk Director (P1-DR) at Bank A (a large-scale bank) articulated this duality as a key strategic challenge:

"For us, risk has two main pillars. The first pillar is the same business risk as other banks: customer defaults, exchange rate fluctuations, system errors. These can be measured; there are models for them. But the second pillar is what sets us apart: Sharia risk. This isn't just about losing money, but about losing legitimacy. Customer trust is built on the assumption that we are 100% Sharia-compliant. Once that assumption is shaken, the impact is far greater than just an increase in NPF (Non-Performing Financing).

This perception was reinforced by a Head of the Financing Division (P5-KDP) from Bank B (a medium-sized bank), who emphasized that Sharia considerations precede commercial considerations in the initial decision-making process.

"Every financing proposal received goes through more than just the 5Cs (Character, Capacity, Capital, Collateral, and Condition). There's a sixth 'C': compliance, or Sharia compliance. If, from the outset, the scheme has the potential to create *gharar* (uncertainty) or fails to meet the contractual requirements, the proposal will not proceed to credit analysis, no matter how promising its business prospects are. This is non-negotiable."

This duality creates a dynamic where risk management focuses not only on mitigating financial losses but also on safeguarding reputation and identity. A member of the Sharia Supervisory Board (P3-DPS) from Bank C (a small-scale bank) described it as follows:

"Our job at the Sharia Supervisory Board is to ensure that this 'sharia fortress' is strong. Management may view risks through the lens of profitability and asset growth. We view them through the lens of compliance with fatwas and *maqasid sharia* (the objectives of sharia). The two must go hand in hand. The greatest risk to Islamic banks is not default, but rather the loss of the 'spirit' of sharia itself.

The Dominance of Risk-Transfer Approaches and the Challenge of Information Asymmetry in Profit-Sharing Contracts

Although the ideal principles of Islamic finance emphasize risk-sharing, field findings indicate a strong dominance of debt-based contracts such as *Murabahah* (sale and purchase) and *Ijarah Muntahiyah bit Tamlik* (lease and purchase) in financing portfolios. Informants pragmatically acknowledged that this preference is driven by the perception of lower risk and ease of management compared to profit-and-loss sharing (PLS) contracts such as *Musyarakah* (partnership) and *Mudharabah* (investment).

A Senior Financing Analyst (P8-AP) at Bank B explained the reasons behind this preference:

"Honestly, around 70-80% of our financing is *Murabahah*. Why? Because the risks are more measurable and can be mitigated in a manner similar to conventional credit. The customer's obligations are clear, and the installments are fixed. We focus on analyzing repayment capacity and collateral. This is more predictable. If we go into *Musyarakah* or *Mudharabah*, there are too many variables. We analyze not only the customer, but also their business, industry, and, most difficultly, their character.

The main challenges in profit-sharing financing, according to informants, are information asymmetry and the potential for moral hazard. This is directly related to Agency Theory, where the bank (*shahibul mal* or partner) has less information than the customer (*mudharib* or managing partner). A Head of the Risk Management Division (P2-KMR) at Bank A elaborated on this issue:

"The biggest risk in Musyarakah is not the inability of the clients to pay, but their honesty. There is the potential for moral hazard; they could underreport profits or engage in side-streaming (diverting income). As banks, we cannot monitor their operations 24/7. This makes monitoring costs very high and the risks difficult to quantify. This is a classic agency problem in the Sharia context.

To mitigate this risk, banks implement a series of stringent procedures, but they are often considered suboptimal. These procedures include in-depth due diligence, periodic requests for financial reports, and on-site visits. However, their effectiveness remains a matter of debate.

"We try to mitigate this by requesting daily cash flow reports for some businesses, and we also agree to use a point-of-sale system connected to ours. But this adds costs and complexity, both for us and our customers. Ultimately, many customers simply prefer Murabahah because it's simpler." (P9-AP, Bank C).

The Central Role of the Sharia Supervisory Board (SSB) as a Compliance Firewall

Research findings firmly position the Sharia Supervisory Board (SSB) as a central element in the risk management architecture, particularly in mitigating the risk of Sharia non-compliance. The SSB's role is not merely passive, providing a stamp of approval, but also actively involved in product development, developing operational procedures, and resolving disputes.

A Head of the Sharia Compliance Division (P6-KKS) at Bank A described the SSB's role as a firewall:

"The DPS is our primary firewall. Not a single product, contract, or even promotional brochure can be released without the DPS's review and approval. They ensure every detail, from the contract clauses to the transaction flow, is in line with the DSN-MUI fatwas and the principles of muamalah jurisprudence. This is a front-line risk mitigation process. Prevention is better than cure.

The dynamic relationship between the DPS and executive management is key to the effectiveness of this oversight. There is a healthy tension between management's drive for business innovation and the DPS's Sharia prudential principles.

"Of course, there are discussions, sometimes heated debates. The business team comes up with new, highly innovative and competitive product ideas. Our job at the DPS is to 'skin the idea', identifying potential Sharia violations that may not be apparent on the surface. For example, issues with asset ownership structures in contracts or the potential for fictitious transactions. We are not here to hinder business, but to ensure it is running on the right track." (P4-DPS, Bank B).

The effectiveness of the DPS's role depends heavily on the competence and independence of its members. All informants agreed that a strong DPS is an invaluable asset in maintaining public trust.

"We are very fortunate to have DPS members who not only understand Islamic jurisprudence but also understand modern banking. They can provide solutions, not just prohibitions. When we identify potential Sharia risks in a transaction, we don't immediately reject it, but instead, we sit down with the DPS to explore alternative schemes that are safer and still comply with Sharia." (P1-DR, Bank A).

Risk Mitigation Process in Practice: Integration of Multi-Layer Procedures and Supervision

At the operational level, the Islamic financing risk mitigation process is a multi-layered workflow that integrates conventional credit analysis with Sharia compliance verification. This process can be broken down into several key stages found consistently across all three banks.

1. *Sharia-Compliant Product Structuring*: Risk is mitigated from the outset at the product design level. Each financing product must have a basic structure, transaction flow, and contract documents approved by the Sharia Supervisory Board (SSB).
2. *Initial Screening*: Financing analysts conduct an initial screening not only on the customer's business feasibility but also on the type of business. Businesses that are prohibited (for example, those related to alcohol or gambling) are automatically rejected.
3. *Dual-Layer Due Diligence*:

"When we conduct a survey for Murabahah car financing, we don't just check the condition of the car. We must ensure that the car actually exists at the time of the contract and is already owned by the bank before it is sold to the customer. We must avoid fictitious transactions. Photos, purchase receipts, everything must be complete. This is part of mitigating the risk of gharar and ensuring that the principles of the sale and purchase are met." (P10-AP, Bank A).

- Financial Layer: Adapted 5C analysis. For example, in the Character aspect, the customer's integrity and Sharia track record are primary considerations.
- Sharia Layer: Verification that the transaction object (goods in Murabahah or projects in Musyarakah) actually exists, is halal (permissible), and has beneficial value.

1. Contract Standardization and Execution: The use of standard contracts approved by the SSB serves as the standard for mitigating legal and Sharia risks. The contract signing process is often explained in detail to the customer to ensure understanding and avoid future disputes.
2. Post-Disbursement Monitoring: Post-disbursement monitoring of financing varies depending on the type of contract. For Murabahah, the focus is on smooth installment payments. However, for Musyarakah and Mudharabah, monitoring is much more intensive.

"For Musyarakah projects, we have a team that regularly visits project sites. We compare progress reports from clients with actual conditions on the ground. We also audit the financial reports they submit. This is our effort to minimize information asymmetry, although we recognize that it will never be completely eliminated." (P7-KDP, Bank C).

An Emerging Integrative Risk Mitigation Model from Practice

Based on thematic analysis of the overall data, a conceptual model of the Islamic financing risk mitigation framework implemented by practitioners can be formulated. This model is not a formal framework written in a single document, but rather a working model reflected in policies, procedures, and the narratives of informants. This model can be described as a Three-Layer Integrative Risk Mitigation Framework.

This framework integrates elements of Sharia Compliance Theory, Risk Theory, and Agency Theory into a coherent structure.

Layers	Layer Name	Main Focus	Key Actors	Main Activities	Relevant Theories
Layer 1: Foundation	Sharia Compliance Strength	Ensuring that all activities, products, and policies align with Sharia principles and DSN-MUI fatwas	Sharia Supervisory Board (SSB), Sharia Compliance Division	Sharia Review & Approval, Internal Fatwa, Sharia Audit, Internal Education	Sharia Compliance Theory
Layer 2: Structural	Institutional Risk Management	Managing general banking risks (credit, market, liquidity, operational) within a Sharia context	Board of Directors, Risk Management Committee, Risk Management Division	Risk Appetite Determination, 5C Analysis, Stress Testing, SOP Implementation, Collateral Management	Risk Theory
Layer 3: Transactional	Contract-Specific Risk Management	Managing unique risks in each contract, particularly information asymmetry and moral hazard	Head of Financing Division, Financing Analyst, Account Officer	In-depth Due Diligence, Contract Object Verification, Project Monitoring (for profit-loss sharing contracts), Partnership Audit, Specific Contract Clauses	Agency Theory

Table 3. Three-Layer Integrative Risk Mitigation Framework in Islamic Banking

This model demonstrates that risk mitigation practices in Islamic banking are not a single process, but rather a multi-layered system, each layer having a specific yet interconnected function.

A President Director (P11-DU) at Bank B summarized the logic behind this model without stating it explicitly:

“Managing an Islamic bank is like building a three-story building. The first floor, the foundation, must be solid. That is Sharia compliance, maintained by the Sharia Supervisory Board (SSB). Without it, the building will collapse. The second floor is the structure, namely the standard risk management that makes us prudent as a bank. And the third floor is the interior of each room, namely how we handle the specific risks of each product, whether Murabahah, Musyarakah, or others. All three must be strong and integrated to make this building safe and comfortable to live in.”

These findings indicate that practitioners, through experience and adaptation, have organically developed a sophisticated framework for navigating the complex risk landscape in Islamic banking. This framework forms the core of the Islamic financing risk management model currently operating in Indonesia.

Interpretation of Findings: Navigating Risk Duality Through a Three-Layer Integrative Framework

The central finding of this study is that Islamic banking practitioners in Indonesia do not manage risk monolithically, but rather through an implicit framework that can be articulated as **the Three-Layer Integrative Risk Mitigation Model**. This model is not a formal blueprint, but rather a working model internalized in daily policies, procedures, and decision-making processes. The emergence of this model can be interpreted as an adaptive and pragmatic response to a fundamental challenge facing the industry: the duality of risk between commercial imperatives and Sharia compliance imperatives.

As revealed by informants, risk is not only viewed as the potential for financial loss (credit, market, and operational risk), but also as the potential for violations of Sharia principles that could threaten the bank's legitimacy and survival. This duality creates an arena where tensions between the three theoretical pillars—Agency, Risk, and Sharia Compliance—exist simultaneously. The identified Three-Layer Model is a mechanism developed by practitioners to navigate and balance these tensions.

The First Layer: The Sharia Compliance Fortress, serves as the foundation. This finding confirms that Sharia compliance is not simply one type of risk, but rather the foundation of the entire risk management architecture. The central role of the Sharia Supervisory Board (SSB) as the primary firewall underscores that risk mitigation begins with ensuring that every product and process is Sharia-compliant before being exposed to market or credit risk. This is a manifestation of Sharia Compliance Theory in its purest form, where preventing Sharia non-compliance risk is an absolute priority to maintain stakeholder trust and mitigate catastrophic reputational risk.

The second layer, **Institutional Risk Management**, reflects the application of Risk Theory in a general banking context. In this layer, Islamic banks adopt proven risk management tools, such as the 5Cs analysis, risk appetite determination, and stress testing. However, their application is not generic. Findings indicate a "shariaization" of these tools; for example, the Character aspect of the 5Cs analysis is expanded to include integrity and the customer's sharia track record. This layer demonstrates the industry's pragmatism in managing quantifiable risks while remaining within the boundaries established by the sharia compliance foundation layer.

The Third Layer: Contract-Specific Risk Management, is the arena where Agency Theory becomes most relevant and prominent. The findings regarding the dominance of risk-transfer contracts (Murabahah) and the challenges of information asymmetry and moral hazard in risk-sharing contracts (Musyarakah and Mudharabah) directly reflect the classic agency problem. Banks, as principals (in Mudharabah contracts) or partners (in Musyarakah), face uncertainty due to the superior information possessed by customers (agents). Mitigation procedures implemented at this layer—such as in-depth due diligence, intensive project monitoring, and partnership audits—are concrete efforts to reduce information asymmetry and agency costs. The preference for Murabahah can be interpreted as a strategy to avoid the complexity and high agency costs inherent in profit-sharing schemes.

Thus, the Three-Layer Model is not simply a list of procedures, but rather an integrated system that addresses an identified research gap: how the three theories interact at the implementation level. The model demonstrates that, rather than clashing, practitioners have found a way to align the three within a logical hierarchy: Sharia Compliance as the foundation, Institutional Risk Management as the structure, and Contract-Specific Risk Management as the transactional operational mechanism.

Dialogue with the Literature: Confirmation, Contradiction, and a New Synthesis

The findings of this study dynamically dialogue with the existing literature, confirming several studies while also offering a new synthesis that enriches understanding.

Confirmation of Existing Literature: The findings regarding the dominance of debt-based financing, such as Murabahah, are highly consistent with global and national literature identifying the phenomenon of "Murabahah syndrome," or a shift from risk-sharing to risk-transfer practices (Rustam, 2024). This study provides rich qualitative evidence regarding the pragmatic reasons behind this phenomenon, namely a more measured perception of risk and efforts to avoid agency problems, which confirms previous theoretical arguments.

Furthermore, the identification of information asymmetry and moral hazard as key challenges in Profit and Loss Sharing (PLS) financing echoes the findings of numerous previous studies (Syahri & Harjito, 2020). These theoretically addressed agency relationship issues, and this research lends a voice to practitioners experiencing these dilemmas firsthand. The findings regarding mitigation efforts through rigorous monitoring align with recommendations in the literature, but also highlight practical limitations and high implementation costs.

The central role of the Sharia Supervisory Board (SSB) as a pillar of Sharia non-compliance risk mitigation also corroborates previous studies on the importance of Sharia governance. These findings support the conclusions of Karimah (2022b), who highlighted the crucial role of the SSB in maintaining Sharia integrity and mitigating reputational risk. This research enriches understanding by portraying the SSB not merely as an auditor, but as a proactive firewall involved from the product design stage.

New Synthesis and Contribution to the Research Gap: This research's primary contribution lies in its ability to bridge the gap between fragmented theoretical discussions and integrated implementation realities. While Fatihin et al. (2024) quantitatively identified the types of risks that influence risk, this research explores "how" and "why" these risks are managed through a coherent system.

The most significant synthesis is the formulation of a Three-Layer Integrative Risk Mitigation Model. This model represents a conceptual contribution that has not been explicitly articulated in previous literature. Existing literature tends to discuss Agency Theory, Risk Theory, and Sharia Compliance Theory separately or, at most, discusses the interaction between the two theories. This model, in contrast, demonstrates how the three not only interact but are structured within a logical hierarchical architecture in the minds and practices of risk managers.

Hierarchical Layers	Mitigation Focus	Practical Manifestations	Dominant Theoretical Framework
Layer 1: Foundation	Sharia Compliance & Reputation Risk	Sharia Review & Approval by DPS, Internal Sharia Audit, Internal Fatwa	Sharia Compliance Theory
Layer 2: Structural	Institutional Risk (Credit, Market, Operational)	Customized 5C Analysis, Risk Appetite Framework, SOPs, Collateral Management	Risk Theory
Layer 3: Transactional	Contract-Specific Risk (Information Asymmetry & Moral Hazard)	In-depth Due Diligence, PLS Project Monitoring, Verification of Contract Objects, Specific Contract Clauses	Agency Theory

Table 4. Conceptual Model of Integrative Risk Mitigation in Sharia Financing

This model effectively fills a research gap by providing an integrative framework that explains how theoretical dilemmas and tensions are resolved in operational practice. It goes beyond simply identifying risks to offer a holistic process model.

4. Conclusion

This qualitative research in-depth investigates financing risk management practices in Islamic banking in Indonesia and successfully articulates an implicit working model implemented by practitioners. Key findings indicate that risk management is not implemented as a single adaptation of a conventional framework, but rather as a complex, integrated architecture to navigate the fundamental duality between commercial imperatives and Sharia compliance imperatives. The

model that emerges from this practice can be conceptualized as a Three-Layer Integrative Risk Mitigation Model. The first and most fundamental layer is the Sharia Compliance Bastion, which serves as a philosophical and operational foundation, driven by the Sharia Supervisory Board (SSB), to mitigate the risks of Sharia non-compliance and reputational risk. The second layer is Institutional Risk Management, which adopts and adapts universal banking risk management tools (such as 5C analysis and stress testing) to manage credit, market, and operational risks within the Sharia framework. The third layer, which is transactional in nature, is Contract-Specific Risk Management, which specifically focuses on mitigating unique risks arising from each financing scheme, especially addressing the problems of information asymmetry and moral hazard in profit and loss sharing-based contracts as explained by Agency Theory.

Thus, this study conclusively addresses its stated research objectives. First, it successfully analyzes and maps the currently operating risk management model, revealing it to be a sophisticated, multi-layered system rather than simply a collection of fragmented procedures. Second, by articulating the Three-Layer Integrative Risk Mitigation Model, this study effectively formulates a comprehensive framework derived from field practice. The formulation of this model directly bridges a previously identified research gap, where the literature tends to discuss Agency Theory, Risk Theory, and Sharia Compliance Theory separately. This study demonstrates how practitioners have pragmatically integrated these three theoretical pillars into a logical and functional hierarchy to achieve financial stability while maintaining Sharia integrity.

The original contribution of this study is multifaceted. Theoretically, it proposes a new conceptual model—the Three-Layer Integrative Risk Mitigation Model—that enriches the Islamic financial risk management literature by providing a holistic framework. This model shifts the discourse from mere risk identification to an understanding of an integrated mitigation architecture. Practically, this model can serve as a diagnostic tool for Islamic banking practitioners to evaluate and strengthen their internal risk management framework, ensuring an effective balance between the three layers. For regulators, the findings provide in-depth insights into de facto practices in the industry, which can serve as a foundation for designing more contextual and effective supervisory policies, particularly in promoting risk management in more complex profit-sharing contracts.

While this study provides rich insights, its findings open several crucial avenues for further research. Future research directions are recommended to focus on quantitative validation of the relationships between layers in the proposed model, to quantify the statistical impact of the strength of one layer on the performance of another. Cross-country comparative studies are also needed to understand how different regulatory and cultural contexts may influence the evolution of risk management models. Furthermore, longitudinal research would be valuable to examine how these models adapt to financial technology (fintech) disruption and the increasing digitalization of Islamic banking services. Finally, a more focused qualitative exploration of the mitigation mechanisms for agency problem in profit-sharing financing remains a fertile area for further research.

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