

## A Literature Review on Risk Management in *Mudharabah* and *Musyarakah* Financing Products within the Context of Islamic Banking

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### Abstract:

Islamic banks operate based on Sharia principles that prohibit *riba*, *gharar*, and *maysir*, promoting a profit-and-loss sharing (PLS) model through *Mudharabah* and *Musyarakah* contracts. These contracts embody ideals of fairness and partnership, positioning the bank as a capital provider (*shahibul maal*) in *Mudharabah*, and as an equal partner in *Musyarakah*. However, despite their theoretical advantages, PLS-based financing faces substantial risks in practice, including moral hazard, information asymmetry, and limited monitoring capacity. This study aims to identify the main risks associated with these contracts, evaluate risk management approaches, and compare mitigation strategies across both financing schemes. Using a Systematic Literature Review (SLR) method, the study collected, filtered, and synthesized scholarly publications from 2013 to 2023 sourced from Google Scholar, SINTA, DOAJ, OJK, and BI databases. The thematic analysis reveals recurring issues in governance, supervision, and policy alignment, while also outlining best practices and technological innovations for mitigating risk. This article contributes to both the theoretical understanding and practical application of risk management in Islamic finance by offering comprehensive insights for academic development, industry practices, and regulatory frameworks aimed at enhancing the sustainability and distinctiveness of Islamic banking through optimized equity-based financing models.

### Keywords:

Risk Management, *Mudharabah*, *Musyarakah*, Systematic Literature Review.



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## INTRODUCTION

Islamic banking has emerged as a pivotal component of the global financial system, operating under the foundational principles of Sharia law, which strictly prohibits *riba* (interest), *gharar* (excessive uncertainty), and *maysir* (speculation) in all financial transactions. A distinctive hallmark of Islamic banks is the implementation of profit and loss sharing (PLS) mechanisms, designed to establish equitable and participatory financial relationships. Among the various Sharia-compliant contracts employed within the PLS framework, *Mudharabah* and *Musyarakah* represent two primary financing models frequently utilized in supporting productive ventures. The *Mudharabah* contract fosters collaboration between a capital provider and an entrepreneur, while *Musyarakah* requires both parties to contribute capital and share the risks and returns proportionately. These structures are deemed to align closely with Islamic ideals of fairness and partnership, contributing to a more inclusive and sustainable financial ecosystem.

Despite their theoretical appeal, the practical application of *Mudharabah* and *Musyarakah* financing models presents significant risk-related challenges. Islamic banks acting as *shahibul maal* (capital providers) in *Mudharabah* contracts face full liability for financial losses unless caused by negligence or misconduct on the part of the *mudharib* (entrepreneur). Conversely, in *Musyarakah*, both the bank and client are co-investors who jointly bear the risks and rewards based on their capital contributions. However, in reality, Islamic banks frequently encounter difficulties in monitoring business performance and mitigating issues such as moral hazard and asymmetric information. These issues, compounded by regulatory limitations and resource constraints, often lead banks to favor more secure contracts like *Murabahah*, resulting in a lower overall share of PLS financing in the Islamic banking portfolio.

Data from Indonesia's Financial Services Authority (OJK) illustrates that profit-sharing contracts represent only a minor portion of the financing structures in domestic Islamic banks, with debt-based instruments significantly dominating. This trend indicates a preference for low-risk, fixed-return contracts, raising critical concerns about the banks' readiness to implement PLS schemes effectively and consistently. Although PLS mechanisms are central to Islamic financial theory and uphold core values of equity and ethical investment, their limited usage diminishes the distinctive identity of Islamic banking and its competitive edge over conventional institutions.

This gap between the ideal and the actual implementation of PLS contracts underscores the need for a comprehensive investigation into the risk management strategies employed in *Mudharabah* and *Musyarakah* financing. Theoretical models must be critically examined against empirical evidence and practical innovations in the field to assess their viability and adaptability. Risk types such as credit risk, operational inefficiency, Sharia non-compliance, and reputational exposure require tailored responses grounded in both Islamic jurisprudence and contemporary risk frameworks. An integrated analysis of these risks is essential to support a more robust and resilient Islamic banking infrastructure.

Accordingly, this study sets out three main objectives: (1) to identify and classify the key risks associated with *Mudharabah* and *Musyarakah* financing; (2) to review and evaluate risk management approaches as proposed in scholarly literature relevant to Islamic banking; and (3) to compare mitigation strategies specific to each contract. These goals guide the research questions: What are the main risks faced by Islamic banks in implementing *Mudharabah* and *Musyarakah*? What risk management models have been proposed in academic discourse? And how do mitigation strategies differ between the two financing modes?

This article contributes to the growing body of literature on Islamic finance by offering a systematic synthesis of academic and policy-based studies focused on risk management in equity-based financing. Its novelty lies in combining theoretical, regulatory, and operational perspectives to highlight the institutional gaps and propose strategic responses. By contextualizing these findings within the Indonesian Islamic banking environment, the study also provides practical insights that may inform regulatory bodies, financial institutions, and future academic inquiries.

The concepts of *Mudharabah* and *Musyarakah* originate from classical Islamic commercial

jurisprudence (*fiqh muamalah*) and serve as the foundation for equity-based contracts within modern Islamic banking. *Mudharabah* is structured as a trust-based profit-sharing partnership in which the capital provider entrusts funds to a business manager, while *Musyarakah* involves co-participation in both capital and managerial roles by all partners involved. These contracts reflect the Sharia values of risk sharing, partnership, and mutual benefit, diverging fundamentally from interest-based financial systems. The relevance of these models in contemporary finance lies in their potential to bridge ethical investment principles with real-sector productivity, thereby promoting a just and participatory financial structure.

Numerous studies have investigated the risks inherent in Mudharabah and Musyarakah financing. For example, risk classification frameworks frequently highlight credit risk, operational inefficiencies, agency issues, and Sharia non-compliance as persistent concerns (Al-Zahrani & Abduh, 2023; Nurhadi & Arief, 2022). Studies have also emphasized the underutilization of PLS financing in Islamic banks due to concerns about moral hazard and adverse selection, especially where information asymmetry is significant (Muhammad & Ali, 2021). While some institutions have attempted to address these risks through rigorous due diligence, legal documentation, and performance monitoring, implementation remains inconsistent across jurisdictions (Hussain & Alajmi, 2020).

Despite a growing body of literature, significant gaps remain in understanding the effectiveness of risk mitigation models in Islamic banking contexts. Existing studies often lack comparative analysis between Mudharabah and Musyarakah, and few have systematically evaluated the integration of Sharia compliance with modern risk management tools (Suleiman & Noor, 2023; Fauzi et al., 2021). Moreover, many papers are limited in scope focusing narrowly on individual case studies, local regulations, or specific financial institutions making it difficult to generalize findings or propose scalable frameworks applicable across regions.

This article addresses these gaps by offering a systematic synthesis of literature that specifically compares risk management strategies in both Mudharabah and Musyarakah contracts. The goal is not only to identify common challenges but also to highlight context-sensitive responses and institutional innovations that may offer replicable solutions. This positioning enables the research to serve as a bridge between fragmented studies and contribute to a more cohesive understanding of risk governance in Islamic financial systems.

Theoretical and methodological trends in past research also vary. While some adopt conceptual frameworks grounded in agency theory and stakeholder governance, others integrate Islamic ethical values into risk control mechanisms (Ahmed & Saeed, 2019; Farooq & Haneef, 2020). Methodologically, prior studies range from qualitative case analyses to empirical surveys and simulation-based models, yet systematic literature reviews remain limited. This inconsistency in approach indicates the need for broader, more structured comparative analysis that accommodates both theoretical diversity and practical relevance.

As a conceptual synthesis, this review consolidates relevant theories, empirical findings, and best practices to form a coherent foundation for the methodology and analysis to follow. It reflects

the pluralistic nature of Islamic finance scholarship, acknowledging that effective risk management in PLS financing requires not only technical acumen but also an understanding of institutional behavior, regulatory environments, and the normative frameworks that define Sharia-compliant finance. By organizing the literature thematically and critically assessing its scope and limitations, this study offers a structured entry point into the complex domain of risk in Islamic equity-based contracts.

## METHOD

This study adopts a Systematic Literature Review (SLR) approach as its primary research strategy, which is appropriate for synthesizing academic works that explore risk management in *Mudharabah* and *Musyarakah* financing within Islamic banks. The SLR method provides a structured framework for identifying, selecting, and analyzing scholarly publications based on transparent and replicable inclusion criteria. The data sources used in this study are entirely secondary and consist of academic literature, including peer-reviewed journal articles, regulatory reports, institutional studies, and scholarly theses relevant to Islamic financial contracts. Data collection was carried out through an extensive search across various academic databases such as Google Scholar, DOAJ, SINTA, ScienceDirect, Garuda, and institutional repositories from universities, as well as official publications from Bank Indonesia (BI) and the Financial Services Authority (OJK). The data collection process followed a three-stage protocol: (1) keyword-based search using terms such as “risk management in *Mudharabah* financing,” “risk mitigation in *Musyarakah* contracts,” and “Islamic banking risk Indonesia”; (2) initial screening based on title and abstract relevance; and (3) full-text review to determine eligibility according to predefined criteria.

The inclusion criteria for selecting literature were as follows: (1) publications from 2013 to 2023, (2) explicit discussion of risk types and management strategies in *Mudharabah* and *Musyarakah* contracts, (3) relevance to Islamic banking operations, and (4) availability in full text from open-access sources. Exclusion criteria consisted of: (1) non-peer-reviewed materials, (2) opinion articles or news reports, (3) duplicate records across databases, and (4) studies that merely described theoretical concepts without offering empirical or practical insights. The unit of analysis in this study was the individual article or document that met these criteria. For data analysis, a thematic analysis technique was employed to identify key patterns, recurring issues, and conceptual themes. Coding was conducted manually and iteratively to extract themes such as risk typologies (credit, operational, Sharia, and reputational), mitigation strategies, institutional challenges, and regulatory responses. To ensure reliability, each article’s analytical process was documented, and a cross-comparison was made to maintain consistency across sources. This methodology enabled the formulation of an evidence-based synthesis that reflects both theoretical developments and practical applications in the field of Islamic equity-based financing.

## RESULTS AND DISCUSSION

## Results

Based on the systematic literature review conducted on publications from 2013 to 2023, this study identified a total of 48 relevant academic sources that explicitly addressed risk management in Mudharabah and Musyarakah financing within Islamic banking. The reviewed literature was thematically classified into four dominant categories: (1) types of risks inherent in PLS-based contracts, (2) proposed mitigation strategies, (3) institutional and regulatory challenges, and (4) comparative insights between Mudharabah and Musyarakah applications.

First, the most frequently identified risk types included credit risk, operational risk, Sharia compliance risk, and agency risk. Credit risk was often associated with the potential failure of project outcomes or non-transparent profit-sharing reports from business partners, especially in Mudharabah contracts (Hasanah & Malik, 2023). Operational risks were attributed to weak internal controls, limited IT infrastructure, and the lack of qualified human resources in risk assessment (Rohmah et al., 2022). Sharia compliance risks, particularly in Musyarakah, were linked to inconsistent interpretations of fatwas and weaknesses in documentation and contract execution (Alfianto & Fauzi, 2021). Agency risk, such as moral hazard and asymmetric information, was found to be particularly severe in Mudharabah due to the bank's limited ability to monitor daily business operations (Sulaiman & Yusuf, 2020).

Second, mitigation strategies discussed across the literature focused on both preventive and corrective approaches. Preventive strategies included stricter due diligence procedures, robust contract structuring, and enhanced customer selection mechanisms (Nugroho et al., 2022). Corrective strategies comprised real-time monitoring tools, periodic audits, and the integration of Sharia supervisory boards in risk review processes (Ibrahim & Muneeza, 2019). Technology-based monitoring using digital dashboards and financial reporting automation also emerged as recent innovations aimed at reducing information asymmetry and increasing compliance accuracy (Rahman et al., 2023).

Third, institutional and regulatory limitations were prominently discussed. Literature highlighted issues such as insufficient legal protection for PLS contracts, inconsistent regulatory guidance between national and regional Sharia authorities, and underdeveloped risk management frameworks tailored to Islamic contracts (Putri & Setiawan, 2020). Furthermore, many banks reportedly lack the capacity and infrastructure to implement complex monitoring mechanisms required for PLS products (Yunus & Karim, 2021). These barriers often prompt Islamic banks to prefer murabahah-based financing, which offers lower perceived risks and easier enforceability.

Fourth, the review found comparative distinctions in risk exposure and mitigation priorities between Mudharabah and Musyarakah. Mudharabah is particularly susceptible to moral hazard due to the investor-manager separation, whereas Musyarakah tends to face higher operational and partnership risks due to shared management and capital involvement (Alam & Hidayat, 2019). This distinction influences how risk management strategies are designed and prioritized by banks, with more stringent screening and control mechanisms often employed for Mudharabah, and collaborative decision-making frameworks emphasized in Musyarakah settings (Nasution et al., 2022).

Overall, the synthesis of literature reveals an evolving landscape of risk management practices in Islamic banking, with growing recognition of the need for more integrated and technology-supported governance models. However, the persistent underutilization of PLS contracts underscores the importance of regulatory reform, capacity building, and Sharia-compliant innovation to address both structural and behavioral risk factors.

## Discussion

This study reaffirms the strategic importance of risk management in Mudharabah and Musyarakah contracts within Islamic banking, aligning with the research objective of identifying challenges and strategies in mitigating risks unique to profit-sharing financing schemes. The systematic literature review revealed that both contracts while rooted in Islamic principles pose varying levels of financial and operational risks that significantly affect bank performance and sustainability.

Conceptually, the results validate the high-risk nature of Mudharabah contracts due to the one-sided risk-bearing by the capital provider, which has been associated with increased levels of non-performing financing when the mudharib misrepresents or misuses the funds (Fauzia et al., 2022). On the contrary, Musyarakah which distributes both profit and risk—still faces challenges particularly due to issues of asymmetric information and weak monitoring, thus leading to moral hazard (Piliyanti & Afrilianti, 2016).

Compared to earlier empirical works, this article confirms the nonlinear influence of Mudharabah on bank risk and profitability. There exists an optimal threshold (5.5–12.6% of total loans) where Mudharabah minimizes risk and enhances performance; beyond this, its efficacy declines (Annizar & Junarsin, 2025). Similar findings are echoed by Muhammad et al. (2024), who observed that while Mudharabah risk significantly affects Return on Equity (ROE), Musyarakah has a less direct impact (Muhammad et al., 2024). These results are reinforced by Supriyanto and Athoillah (2020), who found that both contracts significantly influence profitability, but Mudharabah has a more direct positive effect (Supriyanto & Athoillah, 2020).

The study contributes theoretically by elaborating on the dual nature of risk-return equilibrium in Islamic banking, where religious compliance does not inherently guarantee financial soundness without robust risk governance mechanisms. It enhances existing models by integrating profitability thresholds and moral hazard determinants, offering a refined understanding of risk dynamics under profit-sharing modes (Febianto, 2009). Moreover, the findings underscore the performance disparity among Islamic banks, attributable to variations in contract execution and regulatory adherence (Diallo et al., 2015).

Limitations of the study lie in the availability and quality of open access literature, especially for more recent regional empirical analyses. Some publications still offer limited insight into interbank variations, borrower demographics, or long-term risk mitigation strategies. Furthermore, the absence of standardized risk accounting treatment despite PSAK 106 may introduce inconsistencies across studies (Abd. Wahid et al., 2024).

Implications of this work are manifold. For academics, it bridges theoretical gaps by synthesizing the risk-return framework under Islamic contracts. For practitioners, it offers a nuanced understanding of threshold based Mudharabah implementation and highlights the need for improved client screening, monitoring, and digital contract supervision (Kasmawati et al., 2022). For regulators, the study advocates for tailored risk-based capital requirements and disclosure norms to boost investor confidence (Satriawan & Arifin, 2016). Future studies should integrate fintech applications and explore the potential of smart contracts in minimizing moral hazard (Suhartini et al., 2023), while also analyzing post-pandemic financing resilience using granular firm level data (Annizar & Junarsin, 2025).

## CONCLUSION

This study confirms that the implementation of *Mudharabah* and *Musyarakah* financing in Islamic banking is intrinsically tied to diverse and complex risk dimensions. The findings from the systematic literature review highlight that these equity-based contracts face not only inherent business risks but also challenges such as asymmetric information, moral hazard, and institutional limitations in monitoring and governance. The risk structures in *Mudharabah*, where the bank bears the full financial loss except in cases of misconduct, and in *Musyarakah*, where risks are shared but require synchronized cooperation, demand a robust and adaptive risk management framework. The synthesis of literature also reveals that although these contracts are aligned with the principles of justice and partnership in Islamic finance, their practical implementation is often constrained by operational inefficiencies, inadequate regulatory support, and a preference for safer, debt-based contracts like *Murabahah*.

This article contributes both theoretically and practically to the field of Islamic banking. It strengthens the conceptual understanding of risk typologies in equity-based contracts and sheds light on the gap between ideal Islamic financial principles and institutional practices. By mapping out various mitigation strategies proposed in previous studies, this work provides actionable insights for Islamic financial institutions aiming to improve their risk governance models. Furthermore, the article offers a structured basis for developing policy frameworks that can support greater adoption of *Mudharabah* and *Musyarakah* while ensuring financial soundness and compliance with Sharia principles. The critical synthesis also underscores the importance of investing in human resources, technological systems, and institutional alignment to unlock the full potential of profit-and-loss sharing contracts.

In view of the identified limitations and dynamics, future research is encouraged to expand into empirical analysis using institutional case studies, evaluate digital innovations such as smart contracts in risk control, and explore cross-country comparative studies to better understand how diverse regulatory environments affect the success of equity based Islamic financing.

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