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Analysis of Internal and External Factors Causing Non-Performing Financing (NPF) in Islamic Banks in Indonesia

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Non-Performing Financing; Islamic Banking; Risk Management; Internal Factors; External Factors

ABSTRACT
Non-Performing Financing (NPF) is a major issue facing Islamic banking in Indonesia, potentially impacting business performance, stability, and sustainability. This study aims to analyze the internal and external factors that contribute to NPF and to examine the control mechanisms and financing risk mitigation strategies in Islamic banking. A qualitative approach, using a literature study, was employed through secondary data analysis sourced from *Otoritas Jasa Keuangan* (*OJK*) reports, laws and regulations, and relevant scientific journals. The study results indicate that NPF is influenced by internal factors—such as the quality of financing analysis, risk management, contract structure, and customer understanding of Islamic financing products—as well as external factors, such as economic conditions, competition between financial institutions, and regulatory changes. NPF control is achieved through the implementation of risk management, encompassing a structured process of risk identification, measurement, monitoring, and control, with the active involvement of management and the Sharia Supervisory Board. This study emphasizes the importance of strengthening comprehensive and adaptive financing risk management to reduce NPF levels and maintain the stability of Islamic banking in Indonesia.

INTRODUCTION

Sharia banking plays an important role in supporting national economic growth and providing Sharia-based financial services. As public demand for Sharia financial services increases, compliance with Sharia law must be maintained, alongside healthy and sustainable financial performance. The growth of Sharia banking has been significant; since December 2023 or early 2024, the number of Sharia entities has reached 33 institutions, consisting of 14 *Sharia* Commercial Banks (BUS) and 19 *Sharia* Business Units (*UUS*) (OJK, 2024).

Sharia banking is positioned as an important part of the Indonesian financial system, particularly in encouraging real-sector growth through Sharia-based financing distribution. Unlike conventional banking, which relies on interest, Islamic banks operate on profit-sharing and buying-and-selling schemes, forming business partnerships between the bank and customers (Bouheni et al., 2016; Thaker et al., 2020; Wan Ibrahim & Ismail, 2015). Despite these differences, Sharia banks still face financing risks that can disrupt business performance and sustainability (Budiman, *et al.*, 2018). This occurs because not all operational processes unfold as planned.

Financing distributed by banks remains vulnerable to unexpected default risks. In pursuit of profit, financing is often extended to high-risk debtors (Istiowati & Muslichah, 2021). Financing risk is a primary concern in banking, as it directly ties to customers' ability to meet payment obligations. In Sharia banks, this risk is influenced by various contracts—such as *murabahah*, *mudharabah*, *musyarakah*, and *ijarah*—making it more complex. High non-performing financing (NPF) ratios in certain periods highlight ongoing challenges in financing risk management for Indonesian Islamic banking (Muthmainnah, *et al.*, 2024).

Messai and Jouini (2013) identify internal bank factors influencing financing risk, including financing analysis quality, supervisory system weaknesses, human resource capabilities, and imprudent financing policies. External factors—such as macroeconomic conditions, customer business stability, regulatory changes, and uncontrollable business environment shifts—also contribute. Such external uncertainties can heighten default potential, even with robust internal processes.

Credit risk arises from a customer's or counterparty's failure to fulfill obligations per the agreement, manifesting as default when a debtor cannot meet payments—commonly termed non-performing financing (NPF) (Agbavor, 2019; Almuraikhi, 2023; Supriyatni & Nurjamil, 2021; Yusuf et al., 2023). Such failures cause losses for Islamic banks, with high non-performing loans proven to weaken bank performance and viability, especially during Asian financial crises (Rahman, et al., 2021).

Credit risk ties to uncertainties in income-generating bank activities. Banks routinely encounter various risks, including deliberate payment defaults by capable customers or unintentional ones due to disasters or uncontrollable circumstances (Sappara, 2021).

Karima, et al. (2024) describe non-performing financing as a key issue in Indonesian Islamic banking, where maturing financing is deemed problematic if unresolved within 90 days or more of the due date. Differences between Islamic and conventional systems necessitate tailored financing distribution rules for supervision and risk mitigation. At the macro level, central banks in Islamic or dual-banking countries implement distinct financial management regulations.

Beyond debtor issues, non-performing financing often stems from banks' lenient distribution practices amid liquidity pressures. This skips rigorous feasibility assessments, leaving business risks unaddressed and eroding financing quality despite established oversight (Darmawanti & Suprayogi, 2020).

Moreover, managing problematic financing grows complex amid competition from conventional and Sharia institutions. Thus, adaptive mitigation strategies are essential, extending beyond reactive solutions to preventive measures against future risks (Mahvi & Siregar, 2025).

Prior studies emphasize quantitative analyses of financial variables' links to NPF or profitability. However, qualitative explorations of how internal and external factors are understood, managed, and mitigated by Islamic banking actors remain limited, particularly in Indonesia. Field-level insights into processes, practices, and challenges are vital for effective risk strategies.

This study qualitatively examines internal and external factors causing financing risk in Indonesian Islamic banks. It aims to uncover risk sources, control mechanisms, and practical mitigation strategies, thereby bolstering industry risk management and performance.

Building on this background, the research questions are: (1) How do internal bank factors and external factors contribute to non-performing financing (NPF) risks in Indonesian Islamic banks? (2) How do Islamic banking actors manage financing risks in daily operations, and what control mechanisms reduce NPF levels? (3) How are financing risk mitigation strategies developed and implemented to adapt to dynamic business environments?

This study's objectives are to analyze internal and external bank factors' influence on NPF risks in Indonesian Islamic banks; to explore daily operational risk management and control mechanisms for lowering problematic financing; and to review mitigation strategy development and implementation for adaptability, ultimately supporting stronger Islamic banking risk management.

The research enriches Islamic banking scholarship, particularly on financing risks and NPF management, complementing quantitative studies with qualitative depth. It offers academic references for Sharia risk management and practical insights for policymakers to enhance financing analysis, supervision, and mitigation—reducing NPF levels for regulators and stakeholders.

METHOD

This study utilized qualitative data sourced from secondary sources. Secondary data were obtained through literature reviews of OJK reports, laws, scientific journals, and risk management documents relevant to the topic (Nafi'ah & Widyianingsih, 2021).

Data analysis employed descriptive techniques. This qualitative descriptive approach interpreted and described issues based on available data. It was selected for financing risk research because it facilitated deeper insights into risk occurrence, decision-making patterns, and control mechanisms via banking actors' experiences.

Karima, et al. (2024) identified non-performing financing (NPF) as a primary issue in Indonesian Islamic banking. Their quantitative analysis of secondary data from sources like BPS revealed influences such as bad loans, exchange rates, economic growth, and interest rates.

Mahvi and Siregar (2025) analyzed NPF mitigation strategies at BSI RFO Medan using a qualitative case study with interviews and document analysis. Findings highlighted restructuring, tightened supervision, and personalized customer approaches, though challenges persisted due to policy inconsistencies and low customer understanding of Sharia financing.

Agustin, *et al.* (2022) examined Sharia bank risk management grounded in Qur'anic and Hadith principles using qualitative secondary data and descriptive analysis. Results indicated effective application when supported by employees embodying prophetic traits: *shiddiq*, *fathonah*, *amanah*, and *tabligh*.

RESULTS AND DISCUSSIONS

1. Factors Affecting NPF (Non-Performing Financing)

Before understanding the factors that cause the emergence of various financing risks, we can first discuss the levels categorized in non-performing loans. From some of the studies described, it is understood that various factors both internally and externally have a great impact on the level of financing risk in Islamic Banking. So, it is also necessary to understand the various forms of late payment or return of financing as well as profit sharing and profit margins by customers causing the collectibility of financing to be determined. The quality of financing is divided into five groups which are based on the risk of possible conditions and compliance of customers in fulfilling their obligations to pay installments and pay off financing.

These groups are: 1) Current financing (collectibility I), there are no arrears because the installments are paid on time. 2) In special attention (collectibility II), there is arrears in payment of principal installments or profit sharing for 1-3 months (not exceeding 90 days), and additional financing facilities (new loans) are still provided, both at the bank concerned and other banks. 3) Less smooth (collectibility III), there are arrears of installments that have passed 90 days, the frequency of account mutations is relatively low, and indications of financial problems or documents that are not strong are identified in the debtor. 4) It is doubtful (collectibility IV), there are arrears of principal installments or profit sharing that have passed 180 days, with weak legal documentation, both in the financing agreement and the binding of collateral. 5) Traffic jams (collectibility V), arrears of principal installments or profit sharing have exceeded 270 days, and operational losses are closed using new loans (Nafi'ah and Widyianingsih, 2021).

This financing group is explained in a study by Nafi'ah and Widyianingsih (2021) that financing is categorized as problematic if it is included in the group of less current (collectibility 3), doubtful (collectibility 4), or stuck (collectibility 5). The quality of financing is used by Islamic banks to assess the ability of customers to pay. Therefore, the quality of financing is maintained so that losses due to non-collectible funds distributed can be minimized.

Credit risk is seen as uncertainty in the implementation of bank business activities to obtain income, where losses can be caused by intentional or accidental payment failures by customers (Sappara, 2021). Maturing financing is considered problematic if it is not resolved within 90 days or more, so this problem becomes a major issue in Islamic banking in Indonesia (Karima et al., 2024). The difference in principle between the Sharia and conventional systems has been recognized, so special supervision is applied to mitigate risks, and macro rules are imposed by central banks in countries that implement the Sharia system.

The ease of financing distribution due to excess liquidity often reduces the accuracy of the feasibility assessment, so that the quality of financing decreases and the potential for default increases (Darmawanti & Suprayogi, 2020). The complexity of non-performing financing management is increasing due to competition with other financial institutions, so mitigation strategies are designed to be implemented effectively, focusing not only on problem solving, but also on future risk prevention measures (Mahvi & Siregar, 2025).

In the results of a study by Mahvi and Siregar (2025), it was found that other challenges faced due to low customer understanding of the concept of Sharia financing. The difference between Sharia and conventional financing has not been fully understood by many customers, especially MSME actors. The impact of late payments or inability to meet obligations is not yet realized by some customers, so their relationship with the bank can be affected. The customer's inability to plan payments is influenced by a lack of understanding of the Sharia financing product. The way Sharia financing works, including the profit-sharing mechanism and the consequences of late payments in a zero-interest system, is not fully understood by many customers.

2. NPF Control Mechanism in Sharia Banking

In the business world, risk is associated with decisions and the level of courage in risk-taking. The relationship between risk and potential profit is understood as a one-way relationship, where the greater the risk taken, the greater the chance of profit obtained. The view of risk is differentiated based on an individual approach. Risk is defined as the possibility of unexpected outcomes that can cause losses if not managed properly (Rahmawati and Nisa, 2024).

Risk is also defined as uncertainty in achieving the expected results. Uncertainty is seen as the main trigger for the emergence of risks in various activities. In a business context, risk is understood as the possibility of events that result in a decrease in income and capital. Overall, risk is associated with the chance of unintended or unexpected negative impacts. This involves the process of optimizing the use of resources so that the set goals can be achieved, as well as the optimal management of labor and other assets. Every action, whether by an individual or a company, is always accompanied by an element of risk.

In general, the similarities in dealing with risks are owned by Sharia and conventional banks. However, additional risks are faced by Sharia banking due to the obligation to comply with Sharia principles. Credit, market, operational, and liquidity risks are faced by Islamic banks due to differences in balance sheet structures compared to conventional banks (Rahmawati and Nisa, 2024). In addition, the complexity of risk is enhanced by the implementation of a profit-sharing system. On the other hand, various aspects of banking services have been influenced by the rapid development of information technology, so banking services are shifted to digital systems to improve efficiency and quality of services. The digital strategy is also implemented by Islamic banks, so that public understanding of the development of digital banking is necessary.

In risk control mechanisms, an understanding of risk management is needed as a structured approach used to identify, measure, assess, establish solutions, supervise, and report risks in every activity or process. The importance of risk management is shown through its role in supporting the achievement of goals, facilitating activities that contain opportunities with appropriate levels of risk, and reducing the likelihood of fatal mistakes (Muffrikha and Latifa, 2021).

3. Implementation of Non-Performing Financing (NPF) Management in Sharia Banking

The standard for the implementation of risk management in banks is divided into three main aspects, namely risk management in general, risk management by type, and risk profile evaluation of the ten main types of risks. These types of risks include credit, operational, liquidity, market, legal, reputational, strategic, compliance, investment returns, and investment risks. To ensure that supervision by the Sharia Supervisory Board (DPS) is carried out properly, the existence of supporting functions needs to be provided so that the implementation of risk management is aligned with Sharia principles (Sulfira, et al., 2024). These functions include: 1) Sharia compliance, 2) Sharia-based risk management and 3) Sharia internal audit.

Research by Rahmawati and Nisa (2024) explains that in the regulation of Islamic banks, the implementation of risk management is carried out by paying attention to a number of aspects, where the implementation of risk management involves several elements, including:

a. Identify Risks

The risk identification process is carried out in Islamic banks to recognize potential risks that can arise in operational activities, including product risks and internal operations. Risk analysis is carried out on various Islamic banking activities to determine the sources of risks, their likelihood of occurring, and their impacts, such as on transactions, financing, management, human resources, technology, and external environmental factors.

b. Risk Measurement

Risk in all aspects of the bank's operations is regularly evaluated as the basis for risk control. Evaluation is carried out using quantitative and qualitative methods, both through the approach set by Bank Indonesia and internal methods according to the bank's needs.

c. Monitoring Risk

Comprehensive risk monitoring is carried out by involving the Sharia Supervisory Board to maintain the operational stability of Islamic banks. Various risks are faced through the application of innovative risk management approaches.

d. Risk Control

An adequate risk control system is mandatory for every bank and is based on established internal policies and procedures. In its implementation, risk control measures are adjusted to the acceptable level of risk and risk tolerance limits.

In Islamic banking, various risks are complex and the number is unlimited (Rahmawati and Nisa, 2024). However, some of the main types of risks inherent in Sharia banks are as follows: Credit or Financing Risk, is seen as an important risk for the bank's sustainability and is related to financing and savings. Losses can occur if contractual obligations are not fulfilled by the related parties. These risks are differentiated into systemic risks and specific risks, and appear in Sharia contracts and profit-sharing financing due to information imbalances.

Market Risk is caused by changes in the value of financial instruments, such as exchange rates, stock prices, bonds, and commodities. The impact of such risks can be mitigated through the implementation of market risk management procedures and adequate information systems. Liquidity Risk occurs when the availability of funds is insufficient to meet financing obligations and needs. In Islamic banks, this risk becomes more complex due to the limited use of interest-bearing instruments and the sale of receivables.

Operational risks are caused by limited human resources and the use of operational systems that require adjustment to the characteristics of Islamic banks. Compliance risks arise due to the non-compliance of Sharia banks with applicable Sharia laws and principles. This risk is managed to minimize the impact of violations against established standards. Legal risks are faced by Sharia banks due to the use of Sharia-based financial structures and contracts that require adjustments to the provisions of national law.

Strategic Risk occurs due to the improper implementation of strategies or failure to adapt to policy changes. This risk is controlled through an internal control system. Reputational Risk is caused by a negative perception of the bank's activities and performance. This risk is reduced through consistent application of Sharia principles. Yield Risk occurs due to changes in the rate of return to customers affected by fluctuations in funding yields. This risk is mitigated through profit planning and the development of Sharia instruments.

Investment Risk arises when losses are borne by banks from profit-sharing-based financing. The impact of these risks is mitigated through the implementation of proper risk management and reporting. This study also explains that the main difference between Islamic banking and conventional banks lies in the basic principles of operations applied. Conventional banks are run based on an interest system, while Sharia banks are operated with Islamic principles that reject riba and emphasize justice and togetherness in transactions. In Islamic banks, transactions are focused on real assets to avoid interest risk, while in conventional banks derivative instruments are used. In addition, risk management policies are developed with compliance with internal, legal, and regulatory policies into account.

Risk management in Islamic banks requires special attention due to the complexity of the risks faced. Various risks of various types emerge, especially in funding using PLS and non-PLS schemes. Therefore, an innovative risk management approach is needed to maintain the operational stability of Islamic financial institutions (Rahmawati and Nisa, 2024). Regarding NPF risk in Sharia Banking, this financing problem is explained in research by Sulfira, et al. (2024), so that the credit risk faced by Islamic banking is closely related to the type of contract used.

Various credit risks are described based on the contract as follows: 1) Akad Murabahah and Istishna'. Financing risks arise when assets have been handed over to the customer, but the obligation to pay installments is not fulfilled in accordance with the agreement. 2) Akad Greetings. Financing risks arise if goods are not delivered on time or the specifications of goods are not met according to the contract. 3) Akad Mudharabah. Financing risk is associated with customer business performance and information mismatches. In this contract, the Islamic bank is positioned as the owner of the funds, while the customer plays the role of the manager. Information imbalances can cause moral hazards, such as financial statements that are not presented correctly, so that profit sharing is affected. 4) Wadiah's Contract. Financing risks faced by banks are in the form of possible damage to the entrusted goods. In addition, the risk of unproductivity also arises in the labor services provided to customers.

Comprehensive risk management and internal control systems are essential. The implementation of risk management needs to be adjusted to the objectives, business scale, policies, and level of complexity of each bank. Based on an understanding of the various types of risks in Islamic banking, risk management can be carried out appropriately, namely: 1) Anti-money laundering and terrorism financing prevention plans have been implemented more effectively through the principle of knowing customers. 2) The role of commissioner at a branch office of a foreign bank is carried out by the responsible party according to the bank's organizational structure. 3) Business complexity includes the diversity of transactions, services, products, and business networks owned.

Risk prevention in Islamic banks is greatly influenced by the evaluations and policies set by the board of directors and commissioners. Risk management policies and strategies are prepared and implemented by the board of directors, including risk exposure management, risk management culture development, and human resource enhancement. In addition, periodic reassessments need to be carried out to ensure the suitability of risk assessment methods. The adequacy of the management information system is determined by the accuracy of procedures, policies, and the determination of risk limits.

CONCLUSION

Non-Performing Financing (NPF) emerges as a critical challenge in Indonesian Islamic banking, driven by internal factors like financing analysis quality, risk management, contract structures, and customer understanding of Sharia products, alongside external influences such as economic conditions, inter-institutional competition, and regulatory shifts. Problematic financing is classified via collectibility systems (less smooth, doubtful, or stuck), stemming from customers' weak repayment capacity and suboptimal prudential distribution. Control relies on structured risk management—identification, measurement, monitoring, and mitigation—complicated by Sharia contracts' vulnerability to information asymmetry and moral hazards, necessitating oversight from the *Sharia* Supervisory Board, directors, and commissioners to uphold compliance, internal controls, and information systems. Comprehensive, innovative risk management is essential for operational stability. For future research, empirical studies could compare NPF mitigation strategies across Islamic banks or quantitatively model human resource and technology enhancements' impact on reducing moral hazards through improved customer education and post-disbursement monitoring.

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