

RISK MANAGEMENT FRAMEWORKS IN ISLAMIC MICROFINANCE: A PATHWAY TO FINANCIAL STABILITY IN HUMANITARIAN CRISIS SITUATIONS

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Abstract

Humanitarian crises such as pandemics, natural disasters and conflicts have had a significant impact on the sustainability of Islamic microfinance institutions. MFIs face credit, liquidity, operational and Shariah compliance risks that threaten their financial stability as their financing focus is on the vulnerable. This article explores a risk management framework that can support the stability of MFIs during times of crisis, highlighting the role of Islamic social finance instruments such as zakat and waqf in supporting risk management. Through a literature review, this article reviews risk identification, measurement, mitigation and monitoring strategies relevant to MFIs. The results show that the integration of zakat and waqf can provide liquidity reserves and help customers affected by the crisis, resulting in reduced financial burden for MFIs. Collaboration between MFIs and social financial institutions can also strengthen the resilience of MFIs in facing crisis and ensure the distribution of assistance in accordance with sharia principles. This study recommends strengthening strategic collaboration and improving risk management capacity through training and diversification. Thus, an effective risk management framework and the integration of Islamic social finance prove to be important in maintaining the sustainability and stability of MFIs and enabling MFIs to support community economic recovery during and after the crisis.

Keyword: *Risk Management Frameworks, Islamic Microfinance, Financial Stability, Humanitarian Crisis*

A. INTRODUCTION

Humanitarian crises such as natural disasters, regional conflicts and pandemics have brought threats to the sustainability of Islamic microfinance institutions. This is because people lose their ability to repay the financing they get from the IMFs. Furthermore, this situation will increase credit risk, which in turn disrupts the liquidity and sustainability of the IMFs. Coupled with the limited capital that IMFs have, economic shocks caused by the crisis will certainly also be a major source of microfinance institutions' failure to survive. The lack of reserve funds causes IMFs to finance their operations only expecting installment payments from the disbursed financing. (Mutamimah et al., 2022)(Khateeb et al., 2023).

The stability of microfinance institutions is necessary to maintain their sustainability. Many previous studies have found that Islamic social finance such as zakat, waqf and sadakah are significant contributors to the stability and sustainability of microfinance institutions, especially during crisis. (Mahomed, Z., & Saba, 2024)(Ainol-Basirah & Siti-Nabiha, 2020)(Samad, 2014). This happens because customers affected by the crisis can be provided with economic recovery assistance due to the crisis using social finance. A recovering economy certainly restores the ability of customers to repay their financing to the IMFs. (Tok et al., 2022)(Khateeb et al., 2023). Such integration of Islamic finance will support the financial stability of the IMFs and if aid is channeled through the IMFs, the distribution can also be ensured to follow Shariah principles. (Mutamimah et al., 2022)(Tok et al., 2022).

Based on the above phenomenon, this paper will explore and analyze the risk management framework in Islamic microfinance that can contribute to the financial stability of IMFs while facing humanitarian crises. The crisis situation that causes IMFs to face various risks requires IMFs to be able to develop effective risk mitigation strategies. Through this literature study, it is expected that a risk management framework will be identified that meets all elements of risk at IMFs including sharia compliance. In addition, it is also expected that the risk management framework will be able to strengthen the financial resilience of the IMFs. Thus,

through this research, a deeper understanding of how to properly manage risks will be obtained so as to ensure the stability and sustainability of IMFs in the face of global crises.

B. Literature Review

1. Islamic Social Finance and Microfinance

Islamic financial instruments are very diverse such as zakat, waqf, and alms. (Mukhid. 2024; Muqorobin & Urrosyidin. 2023). Since the instrument was introduced by the Prophet, its existence was intended for sharing wealth from the rich to the poor. (Fauziah et al. 2023; Ascarya. 2022). This will certainly be very appropriate if it is used as a social tool to help humanitarian crises. Zakat is an act of worship that is specialized for the rich (except zakat fitrah), because the payment of zakat follows the nisab and haul. Zakat is an instrument that reduces social inequality and poverty because the recipients of zakat are explicitly described in the Koran, namely the eight asnaf. (Ibrahim et al. 2020; Kakar et al. 2022). Waqf is also a social instrument because the benefits are intended for the general public. (Razak. 2020; Mohammad Abdullah. 2020) and the benefits can be enjoyed for the long term. Cash waqf can also be used to support the stability of microfinance institutions. (Rana et al. 2020; Mohd Thas Thaker et al. 2020). Almsgiving is a voluntary act of worship with an unlimited amount, but when it comes to overcoming humanitarian crises, the amount of almsgiving contributes significantly in terms of providing assistance to both individuals and communities in crisis-affected areas. (Tok et al. 2022; Karakulah & Muneza. 2024). In principle, all of these instruments aim to improve social welfare and help ensure that the distribution of aid reaches the right target (Mutamimah et al., 2017). (Mutamimah et al. 2022; Simatele & Dlamini. 2020).

Microfinance in this context, is a very appropriate forum for Islamic financial instruments for more professional management in its distribution, especially in times of crisis. Zakat, waqf, and sadaqah can be an additional liquidity for microfinance to continue operating in times of crisis. (Ascarya. 2022; Waldan. 2022). Furthermore, microfinance customers affected by the crisis can also be given assistance using these funds in order to restore the economy. A recovering economy will certainly enable customers to repay the amount of loans made to microfinance (Sangwan et al., 2012). (Sangwan et al. 2020; Malik et al. 2020). Thus, the financial stability and sustainability of microfinance can be maintained through this social finance instrument. (Simatele & Dlamini 2020; Bashaija et al. 2020) Furthermore, the integration between Islamic social finance and microfinance can create a more inclusive financial ecosystem, which can help to address global economic challenges. Ultimately, through such collaboration, crisis-affected communities will be helped in their economic recovery, and microfinance institutions will increase their resilience.

2. Risk Management in Microfinance

The sustainability of microfinance is highly dependent on the implementation of risk management. Various types of risks inherent to MFIs can be managed well if risk management is implemented properly. Credit risk (Siriba. 2020; Ibtissem & Bouri. 2013; Lamichhane. 2023), operational (Adegoke. 2020; Lamichane. 2020; Dabi et al. 2023) market (Carl et al. 2021; Bhatt et al. 2023), liquidity (Hameed & Ghafoor. 2022; Saeed. 2023) even Shariah compliance risk (Mohd Noor et al. 2018; Mutamimah et al. 2022) The risks inherent in Islamic MFIs are the cause of the failure of MFIs to maintain their sustainability. Risk management theory includes a series of activities starting from identifying, measuring, controlling and reviewing risks (Van Greuning, H., & Bratanovic. (Van Greuning, H., & Bratanovic. 2020; The International Organization for Standardization. 2018; Amraoui et al. 2019). Conducting risk identification means that MFIs develop a series of processes to find sources of risk. (Durango-Gutiérrez et al. 2023; Bardhan et al. 2021). This is important so that MFIs are able to recognize exactly what risks the MFI may face. This identification is the basis for MFIs to measure how big the potential risk is and how severe the impact will be if the risk occurs (Lamichane. 2021). (Lamichane. 2020; Tadele, H., Roberts, H., & Whiting. 2022; Singh. 2024). If MFIs are able to conduct this analysis appropriately, then formulating risk mitigation measures will be easy. Risk mitigation requires addressing the risk directly to the root cause. (Hubbard. 2020), and risk measurement will help MFIs determine which risks are more prioritized to be handled. (Lamichane. 2020; Tadele, H., Roberts, H., & Whiting. 2022). The implementation of such risk management will help maintain the stability of the MFI and ensure the sustainability of the MFI.

When associated with Islamic microfinance, risk mitigation can be done by diversifying the financing portfolio. (Mutamimah et al. 2022; Ozdemir et al. 2023; Katterbauer & Moschetta. 2022) and the use of capital sourced from social funds. (Eka Saputra et al. 2022; Fersi & Boujelbène. 2023; Ascarya. 2022) and has a more

flexible variety of Islamic financial products (Fersi & Boujelbène, 2023; Ascarya, 2022). (Fersi & Boujelbène, 2023; Katterbauer & Moschetta, 2022; Ozdemir et al. 2023). Risk review, also known as risk monitoring, is needed to ensure that the risk handling steps taken and carried out are appropriate. (Van Greuning, H., & Bratanovic, 2020) and also monitor risks so that surprises do not occur (Van Greuning, H., & Bratanovic, 2020). (The International Organization for Standardization, 2009; Zhemchugova et al. 2022). The application of sharia principles is also an important part of carrying out risk management. Risk mitigation must be ensured that it does not conflict with sharia principles. (Karimah, 2022; Eka Saputra et al. 2022) as well as avoiding the practice of maysir, gharar and usury (Aravik & Tohir, 2023; Isaac, 2023). The application of sharia principles not only ensures sharia-compliant MFIs but can also create a more ethical and sustainable financial system. (Awan & Sabir, 2023; Wanke et al. 2022). So far, it is the Islamic financial system that has proven to be crisis resilient (Rabbani et al. 2021; Cheong, 2021).

C. Method

This research uses a literature review approach to identify and assess relevant risk management frameworks in the context of Islamic microfinance. The focus of the literature is on humanitarian crises that affect the stability of MFIs, such as pandemics and natural disasters. The analytical framework is based on the grouping of four main components of risk management: Identification, Measurement, Mitigation, and Monitoring. Furthermore, the financial stability risk mitigation element is based on the use of Islamic social finance (zakat, waqf). There is also an evaluation of the effectiveness of risk management strategies in maintaining the continuity of MFI operations contained by various articles reviewed.

D. Result and Discussion

1. Risk Management Framework in Islamic Microfinance

The risk management framework is a general guide to the management of risk in an organization. Institutional risk management will be effective if the framework is applied correctly. The framework can be explained as follows:

a. Risk Identification

Risk identification in Islamic microfinance institutions is to determine the types of risks inherent in MFIs. The risks inherent in Islamic MFIs include 4 main types of risks, namely credit, operational, liquidity and compliance with sharia principles. Credit risk occurs due to the loss of customers' ability to repay the financing made to the MFI. In a crisis, this loss of ability to pay will increase due to the deteriorating economy. During the Covid-19 pandemic, for example, the amount of increase in non-performing financing jumped very high. This puts great pressure on financial institutions, especially MFIs that have limited capital, resulting in liquidity problems and pressure on MFI profitability. (Ben Salem, A., Ben Abdelkader, I., Jouda, 2023; Mutamimah et al. 2022).

Operational risk is also the risk with the largest portion that occurs in MFIs. Inadequate managerial competence (Mutamimah et al. 2022; Fersi & Boujelbène, 2023) and the lack of infrastructure and technology facilities (Hussein Kakembo et al. (Hussein Kakembo et al. 2021; Hamzah et al. 2024) making it difficult for MFIs to grow. Exacerbated by the crisis, this situation certainly makes it more difficult for MFIs to get worse. (Mennawi, 2020).

The next risk identification is on liquidity risk. MFIs are said to experience liquidity risk if they are unable to fulfill their immediate obligations. (Uquillas & Simbaña, 2022; Eka Saputra et al. 2022) Liquidity risk can be caused by a number of factors, such as the withdrawal of deposits by customers, financing payments by the MFI itself or the number of financing applications that cannot be disbursed by the MFI to its customers. Liquidity risk often arises due to the mismatch of assets that can be immediately monetized with the amount of MFIs' immediate bills. (WILLIAM MUFFEE, 2020). In times of crisis, such events have a very high probability of occurring so that MFIs can experience shocks to their stability. The last risk that is also an important point for Islamic MFIs is the risk due to the inability of MFIs to fulfill sharia principles in carrying out their operations. This risk is actually a secondary risk, a risk that arises due to other risks. For example, when MFIs need some funds to fulfill their liquidity, Sharia MFIs make loans to conventional financial institutions. Another form can also be in the form of Sharia MFIs ignoring sharia provisions when disbursing financing which makes customers have the perception that there is no difference between Islamic and conventional MFIs. (Mennawi 2020; Suripto, 2023).

b. Risk Measurement and Mitigation

It is important for the MFI to measure how likely the risk is to occur and how severe the impact will be if the risk occurs. If that part has been determined, then Islamic MFIs will easily find a quick and appropriate handling strategy. Risk measurement can be done by using historical data so that future risk projections can be obtained. (Chakraborty & Ghosh. 2020). Various methods can be used to measure risk, depending on the type of risk. So far, the focus of MFIs or financial institutions is still mostly centered on credit risk. Therefore, many credit assessment instruments have been developed to serve as guidelines for assessing creditworthiness, both banking-level financial institutions, and non-banking financial institutions including microfinance institutions. Credit assessment indicators are generally the customer's financial footprint or income capacity. (Fu et al. 2020). Facing a crisis, this indicator will greatly help MFIs document customers who are affected by the crisis and are unable to survive (Meagher, 2020). (Meagher. 2020; Soursourian, M., Plaitakis, A., & Abrams. 2021). This is important so that MFIs can think well if in the future, the same customers make loans again to MFIs.

The risk mitigation strategy that MFIs can implement is to diversify financing. This means that MFIs can diversify the types of financing, the amount of disbursement and the segmentation. This is important to reduce the concentration of financing only to certain groups, which in the event of a crisis and the group loses its ability to pay for the financing, the MFI can be sure to experience bankruptcy soon. (Kassim & Satar. 2020; Mutamimah et al. 2022). Through diversification, MFIs can minimize all risks with a cross-system. For example, if one financing segment is affected by the crisis, the other segments can still be run, so that the MFI's operations remain stable. Risk mitigation can also be done by strict management of assets and liabilities. (Mutamimah et al. 2022; Katterbauer & Moschetta. 2022; Hussein Kakembo et al. 2021).

MFIs must ensure that they are well capitalized. This is important in order to maintain liquidity and overcome various possible risks that occur. Islamic MFIs that carry out two functions, namely business and social, such as Baitul Maal wa Tamwil, can utilize social funds as social capital-based reserve funds. (Awan & Sabir. 2023; Ningrum et al. 2023) The presence of social funds can serve as a liquidity buffer for MFIs. The use of these social funds not only helps MFIs deal with liquidity risk, but can also help MFIs continue to operate sustainably without sacrificing their social mission. If implemented, Islamic MFIs can combine the principles of Shariah-based finance with modern risk management approaches.

c. Risk Monitoring

Completing a proper risk management framework that results in risk reduction is risk monitoring. This is a key element in maintaining financial stability, especially in times of crisis and uncertainty. Changes in both the internal and external environment can lead to changes in risk status. If monitoring is carried out continuously, these changes can be anticipated immediately. The monitoring process can be done by collecting data on an ongoing basis, evaluating the performance of the portfolio and identifying problems that can interfere with the financial performance of Islamic MFIs. The frequency of this monitoring in times of crisis must be intensified because the risk status jumps to a higher level. (Ben Salem & Ben Abdelkader. 2023).

Risk monitoring in particular is useful to see the effectiveness of the strategies developed in risk mitigation. Therefore, at the stage of risk identification and measurement, institutions must be able to estimate the future by collecting accurate data and information from the best sources. If there is a drastic change in circumstances such as a crisis, the institution can adjust immediately to the situation. The application of sharia principles can also help MFIs to be protected from the impact of severe crises. For example, financing using mudharabah contracts where the concept of profit and loss sharing is applied, will certainly provide room for customers with sharia financial institutions to improve in the midst of a crisis. Although in this situation MFIs tend to bear greater risks. But such a scheme can build reputation and customer trust in Islamic MFIs. (Ben Salem, A., Ben Abdelkader, I., Jouda. 2023)

2. Islamic financial stability with risk management

Financial stability in microfinance refers to an institution's ability to maintain sustainable operations in the face of economic pressures and humanitarian crises. As a financial institution that focuses its services on low-income communities, the crisis has increasingly made microfinance institutions the only financial services that provide hope for economic security for the most vulnerable communities. (Malik et al. 2020; Ascarya. 2022; Sangwan et al. 2021). Financial stability also includes the ability of the MFI to maintain its

liquidity in order to meet its financial obligations and anticipate large withdrawals by customers or defaults from financing customers. (Tehulu. 2023; Adusei. 2022). Under these circumstances, risk management will have a very important role to play to ensure that various risks can be addressed in a timely manner. Thus, Islamic MFIs can continue to operate without being disrupted by the crisis.

Maintaining financial stability during a crisis requires flexible and adaptive strategies. Many MFIs have successfully survived the crisis in various parts of the world. The Covid-19 pandemic is one of the toughest tests that MFIs worldwide have to face. Facing this, it turns out that many MFIs have successfully passed the pandemic by implementing restructuring and postponing installment payments. Countries in South Africa and also in Indonesia, are examples that have successfully maintained the stability of MFIs during COVID-19. (Ascarya. 2022; Uddin, M. N., Haque, A., & Anis. 2023). Humanitarian crises due to natural disasters also hit a number of regions in various parts of the world. In these areas, Islamic MFIs are able to survive by relying on capital or reserves sourced from social funds such as waqf and zakat. This is proven to be able to maintain the livelihood of the community and keep MFIs from bankruptcy.

Another strategy that can help microfinance survive the crisis is diversification of income sources. Microfinance institutions in the South Asian region apply this strategy. The allocation of financing is caused by various sectors, especially sectors that will not be affected in the event of a crisis (Fersi & Boujelbène. 2023). (Fersi & Boujelbène. 2023). This method may reduce revenue in the main sector, but can maintain the financial balance of the MFI. The combination of three strategies through financing restructuring, use of social capital and income diversification, it is believed that MFIs can continue to survive during the crisis and will even be the savior of post-crisis economic recovery.

3. Integration of Islamic Social Finance with Risk Management

As mentioned in the literature review section related to Islamic social finance. In this section, the discussion is focused on how Islamic social finance is integrated with MFI risk management. Zakat funds are indeed funds whose allocation has been explicitly explained in the Koran, so the integration of zakat funds is not intended to be a capital enhancer for MFIs, but MFIs can position themselves as institutions that distribute zakat funds that are managed more professionally and responsibly. Customers affected by the crisis can be helped to recover their economy by MFIs through the zakat funds they manage. (Malik et al. 2020; Yerroo & Oumaima. 2023). Waqf is a social instrument that is more modifiable in use, for example, MFIs acquire assets through perpetual grants with waqf contracts. (Mikail, S. I. A., Djafri, F., & Ahmad. 2024; Rana et al. 2020). These assets are well managed to generate profits for the MFIs. The profit can be utilized as social capital for the MFI. If the waqf is in the form of cash, the MFI can become a waqf nadzir who manages the funds productively. (Mafaza et al. 2020; Nurjanah & Hasanah. 2021). These funds can be used as a source of social financing that can help vulnerable groups.

Collaboration between social institutions and microfinance will be a great strength to protect the community from various impacts of economic pressures, especially during a crisis. In addition, microfinance can also use this collaboration as a self-defense in maintaining balance when the economy is not doing well. (Hamed. 2020; Hamzah et al. 2024). This collaboration is also part of what will increase microfinance awareness of its Shariah principles while implementing modern risk management practices. Waqf and zakat funds managed through transparent and standardized systems help ensure that they are used effectively to mitigate risk and support financial stability. Indonesia and Malaysia have provided evidence of successful collaboration between social institutions and microfinance institutions. (Firdaus. 2020). Public welfare has been successfully maintained and improved during the global crisis.

E. Conclusions and Recommendations

Facing the humanitarian crisis, Islamic MFIs need a strong risk management framework to ensure their financial stability and operational sustainability. The use of Islamic social finance instruments such as zakat, and waqf has proven to be effective in helping MFIs face the onslaught of the crisis by strengthening their liquidity. Strength in liquidity will always help MFIs face various other risks such as credit risk, operational risk and liquidity risk itself. Through this literature review, it is known that a risk management framework that includes risk identification, measurement, mitigation and monitoring can be a solid foundation for MFIs in maintaining their financial stability during times of crisis.

MFI sustainability can also be done by collaboration between Islamic social financial institutions and Islamic MFIs. Crisis-affected MFIs can be assisted with zakat funds so that their economic difficulties are

resolved. Waqf funds can be a significant source of liquidity in maintaining the operational continuity of Islamic MFIs. This collaboration can also strengthen the implementation of sharia principles in MFIs. It is hoped that the collaboration of these two institutions can play a vital role in restoring the economy of the post-crisis community, while ensuring long-term financial balance.

Based on this finding, Islamic and even conventional MFIs are advised to integrate social finance instruments in their risk management, especially during crisis. Islamic MFIs in particular, can collaborate with social institutions to utilize social funds such as zakat and waqf as part of risk mitigation. As a modern science, risk management requires good governance to support the implementation of all risk management frameworks. Therefore, capacity building in the implementation of risk management through training and human resource development is needed so that MFIs can continue to adapt to dynamic global economic conditions. Capacity building must also be done to understand sharia principles so that Islamic MFIs remain compliant with sharia provisions in carrying out all operations.

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