JLSCR
Journal of Law and Social Change Review (JLSCR)
Vol. 04, no. 01 (2025), pp. 01-16
Available online https://jurnal.sshpublikasi.com

MORAL HAZARD IN ISLAMIC FINANCIAL INSTITUTIONS: MISUSE OF CUSTOMER FUNDS BY MANAGEMENT AND ITS IMPACTS

Albet Maulana Rahmawan

Faculty of Law, Lampung University, Indonesia
albetmaulana662@gmail.com

Abstract

Sharia financial institutions operating based on Islamic principles face serious challenges in the form of moral hazard, particularly in the misuse of customer funds by management. This study analyzes the phenomenon of moral hazard in the context of Islamic financial institutions, focusing on the behavior of leaders who exploit information asymmetry for personal gain. The results show that moral hazard in Islamic financial institutions occurs through several mechanisms, including manipulation of financial reports, diversion of funds for high-risk investments without customer approval, and use of funds for personal needs of management. Factors triggering moral hazard include weak internal control systems, minimal transparency in operations, and lack of customer understanding of Islamic investment mechanisms. The impact is significant, both economically and socially. Economically, fund misuse causes financial losses for customers, a decline in public trust, and destabilization of the Islamic financial system. Socially, these actions damage the reputation of Islamic financial institutions as a more ethical alternative to conventional systems and erode public trust in Islamic values in business practices. Addressing these issues requires strengthening governance systems, implementing stricter oversight mechanisms, increasing operational transparency, and educating customers about Sharia-compliant investment products and risks.

Furthermore, enforcing strict sanctions against perpetrators of moral hazard and harmonizing regulations between supervisory authorities are key to maintaining the integrity of Sharia-compliant financial institutions.

Keywords: Moral Hazard, Islamic Financial Institutions, Misuse Of Funds, Governance, Customer Trust

A. INTRODUCTION

The Islamic finance industry in Indonesia has experienced quite rapid development over the past two decades. Based on data from the Financial Services Authority (OJK), the total assets of national Islamic banking continue to show a positive trend, with the number of customers increasing every year.[1] This growth is driven by increasing awareness among Indonesian Muslims regarding financial products that comply with Islamic principles, as well as increasingly conducive government regulatory support.

However, behind this encouraging growth, various challenges emerge that threaten the credibility and sustainability of the Islamic finance industry. One of the most serious challenges is the occurrence of moral hazard practices, particularly in the form of misuse of customer funds by the management of Islamic financial institutions. Various cases such as the fictitious financing scandal worth IDR 48 billion at PT Bank Pembiayaan Rakyat Syariah (BPRS) Gayo[2], embezzlement of social assistance funds amounting to IDR 117,982,530,997 by Yayasan Aksi Cepat Tanggap (ACT)[3], and the

[1] Financial Services Authority. (2023). Indonesian Islamic Banking Statistics. Jakarta: OJK. https://ojk.go.id/id/kanal/syariah/data-dan-statistik/statistik-perbankan-syariah/

[2] Special Criminal Investigation Directorate of Aceh Regional Police. (2024). Investigation Report on Fictitious Financing Case at BPRS Gayo. KBA.one. https://www.kba.one/news/bongkar-skandal-rp48-miliar-polda-aceh-geledah-kantor-bprs-gayo-di-aceh-tengah/

[3] MEDCOM. (2022, November 15). Embezzlement of Funds by ACT Used to Pay Employee Salaries and 212 Islamic Cooperative. https://www.medcom.id/nasional/hukum/akWPj6qK-penggelapan-dana-oleh-act-buat-bayar-gaji-karyawan-hingga-koperasi-syariah-212

case of embezzlement of member funds at Koperasi Sejahtera Bersama.[4] in recent years have shaken public trust in the integrity of the Islamic financial system.

Moral hazard in the context of financial institutions can be defined as a situation where one party with more complete information (asymmetric information) exploits its position to make decisions that benefit itself but harm other parties with limited information. In the Islamic finance industry, this phenomenon becomes highly ironic considering that these institutions operate by upholding Islamic moral and ethical values that emphasize honesty, transparency, and justice. The problem of moral hazard in Islamic financial institutions cannot be taken lightly. When leaders or managers exploit their positions and access to misuse customer funds, the impact is not only financial but also damages the fundamental trust that forms the basis of the relationship between financial institutions and customers.[5] This becomes even more problematic because customers of Islamic financial institutions generally choose these products not only for economic considerations but also because of their belief that the institution will operate in accordance with Islamic values.

Cases of customer fund misuse that have occurred in recent years show that moral hazard in Islamic financial institutions can manifest in various forms, ranging from manipulation of financial reports to hide losses, use of customer funds for high-risk investments without adequate approval, to diversion of funds for the personal interests of

[4] Bogor District Court. (2023, July 14). Verdict on Sejahtera Bersama Cooperative Case. CNBC Indonesia. https://www.cnbcindonesia.com/market/20230717105835-17-454917/ini-kronologi-lengkap-kasus-ksp-sejahtera-bersama

[5] Diponegoro University. (2020). Analysis of Moral Hazard Indication in Third Party Fund Distribution: Case Study of Islamic Commercial Banks and Islamic Business Units Period January 2015 – December 2019. Undip Repository. https://eprints2.undip.ac.id/id/eprint/29490/

institutional leaders.[6] These practices not only violate sharia principles but also applicable banking regulations.

The factors that enable moral hazard in Islamic financial institutions are quite complex and interrelated. Weak internal supervision systems, minimal transparency in institutional operations, lack of customer understanding of Islamic financial products, and gaps in regulation and external supervision create loopholes that can be exploited by irresponsible elements.

The impact of moral hazard practices is very broad and multidimensional. Directly, customers experience financial losses which in some cases can deplete their entire savings or investments. Indirectly, public trust in the Islamic finance industry as a whole can be eroded, which in turn can hinder the growth and development of this industry in the future. Furthermore, these cases of abuse can damage the reputation of Islam as a religion that upholds fair and moral economic values.

Therefore, in-depth research and analysis of the phenomenon of moral hazard in Islamic financial institutions becomes very important and relevant. A comprehensive understanding of the mechanisms of occurrence, triggering factors, and impacts will form the basis for developing effective prevention and handling strategies. This article aims to critically analyze various aspects related to moral hazard in Islamic financial institutions, with the hope of contributing to efforts to strengthen the integrity and credibility of the Islamic finance industry in Indonesia.

B. RESULTS AND DISCUSSION

The concept of moral hazard in the perspective of Islamic financial institutions

Moral hazard in the context of Islamic financial institutions is a complex phenomenon and has a special dimension compared to

[6] Indonesian Accounting and Business Review. (2023). Window Dressing Case Analysis in Islamic Rural Banks, Vol. 7 No. 1. https://journal.umy.ac.id/index.php/rab/article/download/17739/pdf/69837

conventional financial institutions. Conceptually, moral hazard can be defined as opportunistic behavior carried out by parties who have more complete information (agent) to make decisions that benefit themselves but harm other parties who have limited information (principal).[7] In the Islamic finance industry, this concept becomes more problematic because it contradicts the basic principles of sharia which emphasize justice (adl), transparency (ifshah), and trustworthiness (amanah).

The Financial Services Authority (OJK) in its supervision of the Islamic finance industry has identified various cross-sectoral issues in financial services including Islamic banking, which includes moral hazard actions. This shows that the problem of moral hazard is not only a theoretical phenomenon but has become a serious concern of regulators in supervising the Islamic finance industry in Indonesia.

The unique characteristics of Islamic financial institutions operating based on the principle of profit-loss sharing (mudharabah and musyarakah) actually create an environment vulnerable to moral hazard. In mudharabah contracts, for example, there is significant information asymmetry between shahibul maal (fund provider/customer) and mudharib (fund manager/financial institution). Mudharib has more complete information access regarding business conditions, investment opportunities, and risks faced, while shahibul maal only relies on reports provided by mudharib.

Mechanisms of moral hazard in Islamic financial institutions

Manipulation of financial reports

One of the most common manifestations of moral hazard in Islamic financial institutions is manipulation of financial reports or what is known as window dressing. This practice is carried out to

[7] Doni Yusuf Bagaskara, Rohmadi, Maretha Ika Prajawati, (2024). Mapping Moral Hazard Behavior in Islamic Banks: Vosviewer Bibliometric Study and Literature Review, Journal of Economy and Banking Ecobankers, State Islamic University Maulana Malik Ibrahim, Malang, Volume 5 Number 1, pp. 59 – 67.

hide operational losses or provide a better picture of institutional performance to customers and regulators. Based on analysis conducted on Islamic Rural Banks, it was found that window dressing practices can be carried out through various misleading accounting techniques.

The mechanism of window dressing in BPRS generally involves premature revenue recognition, postponement of expense recognition, or manipulation of asset classification. These practices not only violate generally accepted accounting principles but also contradict the principles of transparency and honesty in Islamic sharia. As a result, customers make investment decisions based on inaccurate information, which can ultimately harm them financially.

Misuse of funds for high-risk investments

Another form of moral hazard is the use of customer funds for high-risk investments without adequate approval or notification. In this practice, leaders of Islamic financial institutions exploit their position to invest customer funds in instruments or projects that have high profit potential but also very large risks. When the investment is successful, the profits can be enjoyed by the institution and its leaders, but when it fails, the losses are borne entirely by customers.

The case of fictitious financing worth IDR 48 billion at PT Bank Pembiayaan Rakyat Syariah (BPRS) Gayo is a concrete example of this practice. In that case, customer funds were allocated for financing that did not meet eligibility criteria and was even fictitious, causing huge losses for customers who entrusted their funds to the institution.[8]

Use of funds for personal interests

The most extreme manifestation of moral hazard is the direct use of customer funds to fulfill the personal interests of institutional leaders. This practice can take the form of direct withdrawal of funds for personal consumption, purchase of personal assets, or financing the luxurious lifestyle of institutional leaders. The case of

[8] Special Criminal Investigation Directorate of Aceh Regional Police, Op. cit.

embezzlement of social assistance funds amounting to IDR 117,982,530,997 by Yayasan Aksi Cepat Tanggap (ACT) is an extreme example of this practice.[9]

In the ACT case, funds that should have been used for social assistance and humanitarian programs were diverted for various internal operational purposes, including employee salary payments and activities that did not align with the purpose of fundraising. This not only harmed donors but also damaged public trust in Islamic philanthropic institutions.

Factors triggering moral hazard

Weaknesses in internal supervision systems

The implementation of effective corporate governance is a major factor that can improve bank performance, both financially and socially. A good governance system will improve the financial and social performance of banks. However, in practice, many Islamic financial institutions still have weaknesses in their internal supervision systems.

These weaknesses can take the form of organizational structures that do not firmly separate operational and supervisory functions, non-transparent reporting systems, or the absence of effective check and balance mechanisms. Certain risk governance structures, such as the size and independence of audit committees, the expertise of their members, meeting frequency, and quality of external audits, significantly improve risk management effectiveness. When these elements do not function properly, the opportunity for moral hazard becomes greater.

Minimal operational transparency

Transparency is a fundamental principle in the Islamic financial system related to the concept of ifshah (openness). However, in practice, many Islamic financial institutions have not implemented transparency optimally in their operations. This lack of transparency

[9] MEDCOM, Op. cit.

creates space for management to engage in practices that are not in the interests of customers.

Lack of transparency can take the form of unavailability of adequate information about the use of customer funds, investment structures carried out by institutions, or risks faced in operations. Corporate governance mechanisms and risk disclosure by Islamic banks in Indonesia show the importance of transparency in accountability and disclosure. When customers do not have adequate access to information, they cannot effectively monitor institutional performance.

Lack of customer understanding

Another factor contributing to the occurrence of moral hazard is the lack of customer understanding of Islamic financial products and their associated risks. Many customers of Islamic financial institutions have limited understanding of profit-loss sharing mechanisms, Islamic investment structures, and their rights as customers.[10]

This limited understanding makes customers less critical in evaluating institutional performance and less able to identify indications of fund misuse. As a result, moral hazard practices can continue for a long time without being detected by customers.

Gaps in regulation and supervision

Although regulations for the Islamic finance industry have developed rapidly, there are still gaps in supervision that can be exploited to conduct moral hazard practices. OJK has issued new rules aimed at promoting and regulating the growth of Islamic finance, including a memorandum of understanding with the National Sharia Council of the Indonesian Ulema Council (DSN-MUI) in 2014. However, coordination between various supervisory authorities still needs to be strengthened.

[10] Muhammad Zulkarnaen Purnamaputra, Putri Ayu Dhea, Putri Sasya Wilujeng, Risal Fadhil Rahardiansyah, (2022). Moral Hazard Indication and Risk Mitigation Strategy in Mudharabah Financing at Islamic Banking in Indonesia, Al-Muhasib: Journal of Islamic Accounting and Finance, Volume II, Number 1, pp. 119-151.

These regulatory gaps can take the form of differences in supervisory standards between various types of Islamic financial institutions, unclear sanctions for certain violations, or weak law enforcement mechanisms. This condition creates moral hazard at the system level, where perpetrators consider the risk of being caught or sanctioned relatively small compared to the potential benefits from abuse practices.

Impact of moral hazard on Islamic financial institutions

Economic impact

The most direct impact of moral hazard is the financial loss experienced by customers. In extreme cases such as those that occurred at Koperasi Sejahtera Bersama, customers can lose their entire investment or savings. This loss not only impacts the individual financial condition of customers but can also affect the economic stability of families and surrounding communities.[11]

Customer financial losses also have a multiplier effect on the economy. When customers lose their funds, their purchasing power will decrease, which in turn can affect economic activity in other sectors. In the context of Islamic economics, this contradicts the objectives of maqashid shariah, one of which is hifz al-mal (protection of property).

Cases of moral hazard that occur in Islamic financial institutions impact the decline in public trust in this industry as a whole. Trust is the basic capital in the financial industry, and when trust is eroded, the growth and development of the industry will be hampered.

On a broader scale, moral hazard practices that occur systemically can threaten the stability of the Islamic financial system as a whole. When several Islamic financial institutions experience problems due to moral hazard, the impact can spread (contagion effect) to other institutions through various mechanisms, such as bank runs or panic selling.

[11] Bogor District Court, Op. cit.

Social impact

From a social perspective, moral hazard practices in Islamic financial institutions damage the reputation of this industry as a more ethical and moral alternative compared to the conventional financial system. Islamic financial institutions should be examples of implementing Islamic values in business practices, but cases of fund misuse show otherwise.

This reputation damage not only impacts institutions directly involved in moral hazard cases but also the Islamic finance industry as a whole. Society may question whether Islamic financial institutions are truly different from conventional financial institutions in terms of ethical practices.

A more serious impact is the erosion of public trust in Islamic values in economic and business practices. When institutions claiming to operate based on sharia principles are actually involved in unethical practices, this can create skepticism about the relevance and effectiveness of Islamic values in modern economic life.

Islamic financial institutions have important socio-economic functions in society, especially in supporting the economic activities of the ummah and community empowerment. When these institutions experience problems due to moral hazard, their socio-economic functions will be disrupted.

Analysis of moral hazard cases in Indonesian Islamic financial institutions

PT Bank Pembiayaan Rakyat Syariah (BPRS) Gayo case

The case of a fictitious financing scandal worth IDR 48 billion at PT BPRS Gayo is a concrete example of how moral hazard can manifest in Islamic financial institutions. Based on investigations conducted by the Special Criminal Investigation Directorate of Aceh Regional Police, it was revealed that BPRS Gayo management had

engaged in fictitious financing practices that violated the principles of prudence and transparency.[12]

In this case, customer funds were allocated for financing that did not meet eligibility criteria or did not even exist at all. This practice not only violated applicable banking regulations but also contradicted the principle of trustworthiness in Islam. As a result, customers experienced significant financial losses, while public trust in BPRS in the Aceh region decreased drastically.

Yayasan Aksi Cepat Tanggap (ACT) case

The case of embezzlement of social assistance funds amounting to IDR 117,982,530,997 by Yayasan ACT shows that moral hazard does not only occur in formal financial institutions but also in Islamic philanthropic organizations. In this case, funds collected from the community for humanitarian purposes were actually used for operational purposes and internal organizational needs.[13]

This practice is highly contrary to the principles of trustworthiness and transparency in managing ummah funds. Besides causing losses to donors, this case also damaged public trust in Islamic philanthropic institutions and could hinder future social humanitarian activities.

Koperasi Sejahtera Bersama case

The case of embezzlement of member funds at Koperasi Sejahtera Bersama handled by Bogor District Court shows the complexity of moral hazard problems in Islamic microfinance institutions. In this case, cooperative management exploited member trust for personal interests, causing huge losses for cooperative members.[14]

This case is interesting because it occurred in the context of an Islamic cooperative that should apply the principles of togetherness and mutual trust. However, weaknesses in the supervision system and

[12] Special Criminal Investigation Directorate of Aceh Regional Police, Op. cit.
[13] MEDCOM, Op. cit.
[14] Bogor District Court, Op. cit.

operational transparency became loopholes exploited by irresponsible elements.

Strategies for preventing and handling moral hazard

Strengthening governance systems

Strengthening governance systems is a fundamental step in preventing moral hazard in Islamic financial institutions. The use of a comprehensive corporate governance quality index, including board of directors attributes, risk management committees, audit committees, and sharia supervisory boards, shows a significant influence on risk-taking by Islamic banks.

An effective governance system must include several key elements: first, a clear organizational structure with firm separation of functions between operations and supervision; second, implementation of principles of transparency and accountability in all operational aspects; third, formation of special committees such as audit committees, risk committees, and remuneration committees that function independently; and fourth, establishment of clear policies and procedures for all business activities.

Implementation of strict supervision mechanisms

The experience of Islamic banks shows that risk governance mediates the relationship between corporate governance and bank performance. The Chief Risk Officer (CRO) plays an important supervisory role in risk governance and is responsible for monitoring and managing risks well in the organization.

Strict supervision mechanisms must be implemented at various levels: first, internal supervision through independent and competent internal audit systems; second, external supervision by regulators and independent auditors; third, supervision by the Sharia Supervisory Board (DPS) to ensure compliance with sharia principles; and fourth, supervision by customers through provision of transparent and easily accessible information.

Increasing operational transparency

Increasing operational transparency is an important instrument for preventing moral hazard because it reduces information asymmetry between management and customers. Transparency can be increased through various ways: first, provision of comprehensive and easily understood financial reports; second, publication of information about investment structures and allocation of customer funds; third, delivery of risk information clearly and accurately; and fourth, implementation of online reporting systems that allow customers to access information in real-time.

Customer education and financial literacy

Customer education and financial literacy improvement programs are important long-term strategies for preventing moral hazard. Customers who have a good understanding of Islamic financial products will be better able to monitor institutional performance and identify potential fund misuse.

Education programs can include: first, socialization about basic principles of Islamic finance; second, explanation of risks in Islamic investment; third, training on how to read and analyze financial reports; and fourth, information about customer rights and complaint mechanisms.

Strict enforcement of sanctions

Strict enforcement of sanctions against moral hazard perpetrators is an important deterrent element. Sanctions must be proportional to the level of violation and have a deterrent effect. The sanction system can include: first, administrative sanctions by regulators in the form of warnings, fines, or license revocation; second, criminal sanctions in accordance with applicable legal provisions; third, civil sanctions through compensation claims; and fourth, social sanctions in the form of publication of perpetrator names and blacklisting.

Harmonization of regulations and coordination of supervisors

Harmonization of regulations between various supervisory authorities and effective coordination between supervisory

institutions is very important to create a comprehensive and effective supervision system. This can be done through: first, standardization of rules and supervision procedures for various types of Islamic financial institutions; second, formation of regular coordination forums between supervisory authorities; third, sharing of information and data between supervisory institutions; and fourth, harmonization of sanctions for the same types of violations.

C. CONCLUSION

Islamic financial institutions face serious challenges in the form of moral hazard, where leaders or management misuse customer funds for personal interests. This phenomenon is ironic because it contradicts the basic principles of Islam that emphasize honesty, transparency, and justice. Moral hazard occurs through several mechanisms, such as manipulation of financial reports to hide losses, diversion of funds for high-risk investments without customer approval, and use of funds for personal needs of management. The main triggers of this practice are weak internal supervision systems, minimal operational transparency, and lack of customer understanding of Islamic products and risks.

The impact of moral hazard is very broad and significant. Economically, customers experience financial losses, public trust in the Islamic industry declines, and the financial system becomes unstable. Socially, the reputation of Islamic institutions as a more ethical alternative becomes damaged, and public trust in Islamic values in business practices is also eroded. To address these problems, a comprehensive strategy is needed, namely strengthening governance systems, implementing stricter supervision, and increasing operational transparency. In addition, educating customers about Islamic products and their associated risks as well as strict enforcement of sanctions against moral hazard perpetrators are also important keys.

Suggestions for Islamic financial institutions include prioritizing the strengthening of governance by implementing clear organizational structures, separating operational and supervisory

functions, and forming independent committees such as audit committees, risk committees, and sharia supervisory boards. Operational transparency must be increased by providing comprehensive financial reports, publishing information about investment structures, and ensuring risk information is clearly communicated to customers. Implementation of stricter supervision mechanisms is needed at various levels, both internal supervision by competent audits and external supervision by regulators. For regulators and government, it is very important to harmonize regulations and strengthen coordination between supervisory institutions to create an effective system. In addition, strict enforcement of sanctions against moral hazard perpetrators is crucial to provide a deterrent effect.

BIBLIOGRAPHY

Bagaskara, Doni Yusuf, Rohmadi, and Maretha Ika Prajawati. "Mapping Moral Hazard Behavior in Islamic Banks: A Vosviewer Bibliometric Study and Literature Review." *Journal of Economy and Banking Ecobankers*, Universitas Islam Negeri Maulana Malik Ibrahim, Malang, Vol. 5, No. 1 (2024), pp. 59-67.

Special Criminal Investigation Directorate of Aceh Regional Police. *Investigation Report on Fictitious Financing Case at BPRS Gayo*. KBA.one, 2024, https://www.kba.one/news/bongkar-skandal-rp48-miliar-polda-aceh-geledah-kantor-bprs-gayo-di-aceh-tengah/, accessed 20 Dec 2024.

MEDCOM. "Fund Embezzlement by ACT to Pay Employee Salaries and Sharia Cooperative 212." 15 Nov 2022, https://www.medcom.id/nasional/hukum/akWPj6qK-penggelapan-dana-oleh-act-buat-bayar-gaji-karyawan-hingga-koperasi-syariah-212, accessed 20 Dec 2024.

Financial Services Authority. *Indonesian Islamic Banking Statistics*. Jakarta: OJK, 2023, https://ojk.go.id/id/kanal/syariah/data-

dan-statistik/statistik-perbankan-syariah/, accessed 20 Dec 2024.

Bogor District Court. "Verdict on Koperasi Sejahtera Bersama Case." *CNBC Indonesia*, 14 Jul 2023, https://www.cnbcindonesia.com/market/20230717105835-17-454917/ini-kronologi-lengkap-kasus-ksp-sejahtera-bersama, accessed 20 Dec 2024.

Purnamaputra, Muhammad Zulkarnaen, Putri Ayu Dhea, Putri Sasya Wilujeng, and Risal Fadhil Rahardiansyah. "Indications of Moral Hazard and Risk Mitigation Strategies in Mudharabah Financing in Islamic Banking in Indonesia." *Al-Muhasib: Journal of Islamic Accounting and Finance*, Vol. II, No. 1 (2022), pp. 119-151.

Accounting and Business Review of Indonesia. "Analysis of Window Dressing Cases in Islamic Rural Banks." Vol. 7, No. 1 (2023), https://journal.umy.ac.id/index.php/rab/article/download/17739/pdf/69837, accessed 20 Dec 2024.

Diponegoro University. "Analysis of Moral Hazard Indications in Third Party Fund Distribution: Case Study of Islamic Commercial Banks and Sharia Business Units Period January 2015 – December 2019." *Undip Repository*, 2020, https://eprints2.undip.ac.id/id/eprint/29490/, accessed 20 Dec 2024.