

Risk Management Framework in *Zakat*-Based Islamic Microfinance

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Article Info	Abstract
<p>Article history: Received May 19, 2025 Revised Juni 18, 2025 Accepted June 26, 2025</p> <hr/> <p>*Corresponding author email: farhahmahadi@iium.edu.my</p> <hr/> <p>Keywords: Risk Management Framework, Zakat-Based Microfinance, <i>Asnaf</i></p>	<p>Introduction: This study explores the potential of utilizing zakat funds or their proceeds for microfinance initiatives by developing a robust risk management framework. The framework aims to ensure prudential use of zakat resources and align with Islamic ethical and operational principles to enhance the effectiveness of zakat-based microfinance in promoting socioeconomic empowerment. Research Methods: A qualitative approach is employed to analyze the use of Islamic financial contracts such as <i>qard hasan</i>, <i>muḍarabah</i>, <i>musharakah</i>, <i>salam</i>, and <i>ijarah</i> in managing portfolio risks within zakat-based microfinance institutions. Results: The findings indicate that a structured risk management framework improves the financial stability and accountability of zakat-based microfinance institutions. It provides clear parameters for prudential management and helps safeguard zakat funds against potential losses. Conclusion: This study proposes a practical framework that helps zakat institutions balance financial sustainability with their mission of socioeconomic empowerment, enhancing transparency and resilience in zakat-based microfinance.</p>
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INTRODUCTION

The *zakat* institution has incentives to provide financial services to eligible beneficiaries through Shariah-compliant microfinance schemes or mechanisms in a sustained manner that would increase the number of small enterprises, encourage social inclusion, and promote economic development in the society. Eligible beneficiaries who have no access to financial services, no collateral assets and severely limited credit history loans to acquire financing from banking system because lending to them became very risky and very costly. They are extremely difficult to take advantage of economic opportunities, build assets, and protect themselves against financial shocks. The exclusion of the poor from the financial system (financial exclusion) thus, binds them into a vicious circle of poverty.

The *zakat* institution possesses a compelling, *Shari'ah* driven mandate to furnish financial services to its eligible beneficiaries through *Shari'ah* compliant microfinance schemes or analogous mechanisms. This provision must be executed in a sustained manner, aiming for a consequential increase in the proliferation of small enterprises, the advancement of social inclusion, and the resultant acceleration of socio-economic development within the broader community. Crucially, these eligible beneficiaries frequently characterized by a profound lack of access to formal financial infrastructure, an absence of tangible collateral assets, and a severely limited, if not non-existent, credit history are systematically precluded from acquiring financing through the conventional banking system. Lending to this *aṣnaf* is perceived by financial intermediaries as excessively risky and cost-prohibitive, thereby making it extraordinarily difficult for the poor to capitalize on burgeoning economic opportunities, undertake sustainable asset accumulation, or establish a robust defense against unforeseen financial shocks.

This systemic *zakat*-based Islamic microfinance serves to be potentially viable and would be a revolutionary way to assuage poverty. *Zakat* funds may be provided as start-up capital for their micro-enterprises in the form of outright grants, or interest-free loans (*qarḍ ḥasan*), or micro-equity. Hence, poverty alleviation and economic empowerment in a society could be materialised through efficient collection and distribution of *zakat* by the relevant authorities.

The concept of offering microfinance to eligible beneficiaries is adduced from the previously mentioned *ḥadith* in which the Prophet (SAW) auctioned the belongings of a poor man who had come to him asking for financial help. He gave him half the proceeds of the sale for his family's needs, purchased an axe with the other half, and instructed him to go cut firewood and sell it. The *ḥadith* demonstrates how to design and implement a strategy of poverty alleviation through economic empowerment.

Good microfinance programs are characterized by short-term loans—credit is usually given in small amounts, requiring repayment at weekly intervals and within a short period. They also involve immediate disbursement of repeat loans after timely repayment, streamlined borrower and investment appraisal, and convenient service delivery in terms of location and timing. Beneficiaries look forward to repetitive financing in a graduated manner, which helps

prevent default and delinquency risks. Hence, zakat institutions ought to adopt best practices in offering microfinance schemes and improve the efficiency of portfolio risk management to achieve a better equilibrium between sustainability and outreach (Obaidullah, 2008).

A well-crafted and detailed plan is crucial for effective risk management. There are various instances of risk management during the time of the Prophet (SAW). He considered possible contingencies during the hijrah to Madinah when he assigned 'Ali ibn Abi Talib to sleep in his place to deceive the Quraysh, thereby mitigating and diversifying the risk of being killed. Moreover, several Qur'anic verses highlight the importance of financial planning to control and mitigate anticipated and perceived risks. Examples of such practices can be found in the stories of Prophet Nuḥ (AS) in Surah Hud (11:37)—which illustrates the design of well-engineered structures for safety in catastrophic situations—and in the story of Prophet Yūsuf (AS), which provides an example of proactive risk management (Al-Khalidi, 2008; Agha and Sabirzyanov, 2015). Prophet Yūsuf interpreted the king's dream foretelling seven years of drought, advising the cultivation of crops during the first seven years and the storage of most of each harvest as an economic strategy to overcome the coming catastrophe. Surah Yusuf (12:47–49) acknowledges his preparedness during seven years of drought after seven years of prosperity (Agha and Sabirzyanov, 2015).

RESEARCH METHOD

This study employs a qualitative research design with an exploratory approach to achieve a comprehensive understanding of establishing a robust risk management framework for *zakat*-based microfinance, that encompasses data collection, data analysis, and the anticipated outcomes. Against this backdrop, this study is based on an in-depth and extensive literature review of documents and reports from various scholarly and institutional perspectives, thereby providing a deeper understanding of risk management in *zakat*-based Islamic microfinance (Creswell & Poth, 2018).

1. Data Collection

This study primarily employs a robust desk-based research approach, focusing on an extensive review of existing literature. This involves a comprehensive analysis of documented practices from *zakat* institutions, both domestically and internationally, alongside a critical examination of contemporary *fatwas* and recent scholarly work. The data for this study will be sourced from a variety of credible academic publications, including peer-reviewed journal articles, research papers, and editorials, as well as from authoritative professional resources such as institutional websites, official reports, and official documents. This approach, by concentrating on the most recent scholarly outputs, ensures the data accurately reflects the latest advancements and practical insights concerning risk management within the domain of *zakat*-based Islamic microfinance.

This study draws on a combination of printed and online sources, providing a broad spectrum of viewpoints on the concept and interpretation of *zakat*-based microfinance. By utilizing library research, the study gathers detailed information on the theoretical frameworks established by scholars and the potential practical application of *zakat*-based microfinance by relevant institutions.

2. Data Analysis

This study employs two distinct yet complementary methods i.e. qualitative analysis and thematic analysis. The former is used to examine and interpret data from library research, facilitating a detailed exploration of the underlying meanings, concepts, and interpretations concerning risk management in *zakat*-based microfinance, in both theoretical and practical contexts. Thematic analysis is applied to analyse the data collected from the library research. This method helps identify, analyse, and report patterns or themes within the data, providing a structured approach to understanding the diverse perspectives on risk management. Together, these analytical methods provide a comprehensive understanding of the contemporary interpretations of risk management in *zakat*-based microfinance from both academic and practical viewpoints (Braun & Clarke, 2006).

RESULT AND DISCUSSION

The Concept of *Maṣlaḥah* in *Zakat*-Based Microfinance

As part of the effort to unlock *zakat*'s potential to empower less privileged segments of the society, Shari'ah-based research is required to search for a formidable modality to make *zakat* more beneficial and impactful. Such modality had to start by considering the B40 of Malaysia as well as those who are better off but are not wealthy. The next step taken was to devise a Shari'ah-compliant mechanism by which a portfolio for *zakat*-based microfinance could be created from the *zakat* fund.

This was successfully done by segmenting the fund into two portfolios, with the larger portfolio going for immediate disbursement and the smaller portion going for microfinance. *Zakat*-based microfinance, by meticulously vetting beneficiaries for eligibility and assessing their business potential, strategically cultivates successful entrepreneurs through comprehensive training and ongoing consultancy, thereby catalyzing productive employment, vibrant trade, and broader socioeconomic development within the community through the creation of sustainable enterprises and the judicious provision of further capital injections. The *fiqhi* concept that was relied upon was the permissibility of delaying *zakat* distribution due to *maṣlaḥah*, a concept endorsed by a good number of classical jurists (Al-Ghufaylī, 2009; Shabbir, 1998; Al-Ānī, 1999; and OIC Fiqh Academy Resolution No. 165 (18/3), 2007). The permissibility of allocating *zakat* funds for *maṣlaḥah 'ammah* (public welfare) was a position advanced by prominent Islamic scholars, including Rashid Riḍa (1947), Maḥmud Shaltut (1987), and Muḥammad ibn 'Abd al-

Ḥakam. *Maṣlaḥah ‘ammah* includes building military, mosques, charitable hospitals, roads and armies, non-commercial railroads, military airports, fortifications, and military ships, expenses of training and travelling for speakers who spread the word of Allah.

The theory of *maṣlaḥah* is based on the doctrine of need and necessity, whereas interest means something in which one has a concern that is not as pressing as need and necessity. Eminent jurists like Muḥammad Sa‘id Ramadan al-Buṭi (1973), Abu Ḥamid al-Ghazali (1984), al-Juwaynī (1992), al-Razi (1991), Ibn Taymiyyah (1986), Abu Isḥaq al-Shaṭibi (n.d.) and Abu al-Ḥusayn al-Baṣri (n.d) have discussed the concept of *maṣlaḥah*, which constitutes one of the major themes in Islamic jurisprudence (*fiqh*).

Al-Ghazali places the method of reasoning by *maṣlaḥah* subordinate to *qiyas* and provides certain conditions for its validity. He considers *maṣlaḥah* as a valid principle of reasoning if it is in full agreement with Shari‘ah and its objectives. *Maṣlaḥah* as expounded by Al-Shaṭibi is to be the objective of Shari‘ah and he claimed that the premise of *maṣaliḥ* can be established by the method of induction. According to Al-Razi, *maṣlaḥah* and *munasabah* (suitability) are associated with each other. Ibn Taymiyyah (1986) opines *maṣlaḥah* is an integral part of the Divine injunctions whose comprehension requires an adequate methodology comprising rational and revelational components. Scholars of *uṣul al-fiqh* require that a *mujtahid* have adequate understanding of the ultimate goals of Shari‘ah rulings as well as the common interest (*maṣlaḥah ‘ammah*) of people at the time that a ruling on an arising issue is sought.

In order to effectively realize *maṣlaḥah*, *zakat*-based microfinance initiatives empower impoverished beneficiaries with the means for self-sufficiency and foster the success of *asnaf* (eligible) entrepreneurs by providing not only crucial capital for business (al-Nawawi, n.d.; al-Ramli, 1984; al-Mardawi, 1995; al-Baghdadi, 2007; Al-Qaradawi, 1969) and entrepreneurship development but also essential guidance and knowledge.

Al-Nawawi (n.d.) in *al-Majmu‘ Sharḥ al-Muhadhab* says:

“A craftsman would be given an amount sufficient to buy tools and equipment that allow him to work and gain his sustenance. This certainly differs according to time, country, and the ability of individuals. Some of our colleagues give examples that a person who sells vegetables may be given five or ten dirhams, while a person whose profession is selling jewels would be granted ten thousand dirhams if he cannot reach sufficiency with less than that amount. People of other professions would be given according to the requirement of their profession. Farmers would be given farming land or portions thereof that would be sufficient for them to gain sufficiency of sustenance. As for those who have no craft or ability, they must be given sustenance sufficient for the rest of their lives, not restricted to one-year limitations”.

Shams al-Din al-Ramli (1984), the commentator on al-Nawawi's *al-Minhaj*, expresses this concept in the following words:

“It is not necessary to give the poor and needy money to suffice for the rest of their lives; they may be given capital investment whose returns would be sufficient for their maintenance provided that ownership of the property is transferred to the poor and can be bequeathed to their heirs....As for professionals and workers, they should be given the capital necessary for their productive work that would provide them with sufficient income. If a person knows more than one profession, the least amount of capital needed would be given, and if that profession does not produce sufficient income, an added capital investment such as real estate should be granted”.

Microfinance, which entails the extension of small amounts as capital, capital expenditure, and small interest-free loans, was worthy of consideration for making the *zakat* fund more effectively and efficiently benefiting greater number of *zakat* recipients. Based on the preceding scholarly consensus among jurists like Imam al-Nawawi (n.d), Ibn al-‘Arabi (2003), and al-Qurṭubi (2006), the ultimate purpose of *zakat* distribution is to provide sufficient, continuous relief to the poor, with the aim of achieving a suitable standard of living and fostering economic independence for recipients, as articulated by al-Suyuti (1961), who posited that a beneficiary is entitled to the full amount needed to attain self-sufficiency, whether for essential provisions or business capital.

The Concept of Microfinance

When a microfinance institution provides loans based on *qard ḥasan*, it is allowed to recover the cost of operations and actual expenses from the borrower. It is required that any excess charge be refunded back to the borrower after the actual operational costs are ascertained at the end of the accounting period. AAOIFI in its Shari‘ah Standard No. (19) stipulates that Islamic financial institutions can only charge direct costs and expenses related to the disbursement of the debt. Therefore, the majority of Muslim jurists have agreed that all administrative costs and expenses related to the debt or financing must be borne by the debtor, as the purpose of the service and expenses is to facilitate the disbursement of such debt. In such a case, any costs that are charged over and above the amount of direct and actual incurred costs would be considered *riba*.

The Council of the International Islamic Fiqh Academy (IIFA) in Resolution No. 13 (1/3), regarding a service fee for IDB loans, stated that it is allowed to charge a fee for loan-related services. The said fee should be within the limit of the actual expenses; and any fee in addition to the actual service-related expenses is prohibited (*ḥaram*) because it is considered *riba*. Financing on the basis of *qard ḥasan* can be backed by a guarantee under the concept of *kafalah*. It is essential to note that the application of *kafalah* in Malaysia is governed by the Contracts Act, 1950.

Zakat-Based Microfinance

However, the big challenge was the sensitivity to using *zakat* for Islamic microfinance. The common initial reaction to such proposals is scepticism. This is because contemporary scholars have tended to restrict the scope of investment of *zakat* funds in their various fatwas, and this consequently limits the possibility of *zakat*-based Islamic microfinance. Muslim jurists and leading scholars from various schools of thought, including Al-Karkhī, Ibn al-Humam ([Al-Shawkani, 1414H](#)), Malik, al-Shafi'i, and Aḥmad ([Al-Qaradawi, 1969](#)), concur that the fulfillment of *zakat* obligations is a profoundly immediate duty, rooted in the principle that it is an essential right of the poor and a good deed that should not be postponed ([Al-Shawkani, 1427H](#)) as mentioned in Surah al-Tawbah, 9:60, *zakat* funds should be disbursed immediately to the right beneficiaries; consequently, a delay without a valid justification is deemed sinful ([Al-Nawawi, n.d.](#); [Al-Qaradawi, 1984](#)), and in the event of an unavoidable delay, jurists like Shams al-Din al-Ramli (1984) maintain that the *zakat* institution is responsible for compensating the due amount if the wealth is destroyed or lost.

However, this study, relying on the principle that the Shari'ah has a solution to any emerging problem, made efforts to proffer a solution that will protect the Shari'ah objectives of *zakat* without putting the money at risk. The study relied on the existing *fatwa* that permitted investment of *zakat* with strict conditions and the Prophetic traditions that set parameters for giving priority to some potential *zakat* recipients over others. 'Abd Allah ibn 'Amr ibn al-'As (May Allah be pleased with them) reported that the Messenger of Allah (SAW) said: “*Ṣadaqah* is not permissible for a rich person, nor for one who is strong and sound in limb.” Narrated by Tirmidhī and Abu Dawud. In another narration: “for one who is strong and sound in limb.”

Drawing from the prophetic tradition narrated by 'Abd Allah ibn 'Amr and authenticated by al-Tirmidhi and Abu Dawud, it is established that *zakat* funds are not permissible for an individual of means or one who is physically capable (*qawī*) and *sawī* (sound in limb) able to earn a living, with the jurist al-Khaṭṭābi clarifying that '*dhu mirrah*' denotes robust physical health suitable for strenuous work. The *mafhum al-mukhalafah* (the inverse meaning) of this variation is that *zakat* is lawful for those who are not endowed with healthy limbs and have no source of earning. An esteemed Ḥanafī jurist, Al-Ṭahawī argued that being healthy is not a factor that prohibits entitlement to *zakat* if the recipient's intention is survival, but it is *haram* for him to collect the *zakat* if his intention is enrichment ([Ibn al-Jawzi, n.d.](#)).

In the event of an abundant and well-resourced *zakat* fund with a surplus, the opinion of Abu Ḥanifah, Abu Yusuf, Muḥammad ibn Ḥasan and Imam Malik that every poor and needy person is qualified to receive *zakat*, regardless of having healthy limbs and with or without a regular source of earning ([Ibn Battal, 2003](#)). This is aligned with the objective of *muwasah* as it ensures that the designated recipients are entitled to a share, thereby providing essential aid to those in need. *Muwasah* is a foundational Islamic concept encompassing a holistic and empathetic approach to rendering assistance, consolation and comfort to those in need.

Conversely, in situations where *zakat* revenue is limited, scarce and insufficient to serve a large number of beneficiaries, the more restrictive positions of the Shafi'i and Hanbali schools may offer a more practical approach. Imam al-Shafi'i, Ishaq ibn Rahawayh, Imam Ahmad ibn Hanbal, Abu Thawr, Abu 'Ubayd, Ibn al-Mundhir, Ibn al-Qassar, and most importantly, it is the opinion of 'Abd Allah ibn 'Amr, the Companion who reported the *hadith*.

Therefore, *zakat*-based microfinance is designated for potential recipients who, though physically sound, require capital to realize a sustainable livelihood, and for actual recipients, who are either able-bodied but without income or are temporarily or permanently unable to work. Based on the principles of *hadd kifayah*, this *zakat* allocation is designated to provide for his fundamental subsistence needs, and he may further be considered for *zakat*-based microfinance pending a sound demonstration of his entrepreneurial viability. Incapacitated individuals, while eligible to receive *zakat* due to their inability to work, are disqualified from receiving microfinance funding. This is to mitigate the significant risk of default and delinquency that their circumstances present.

The study studies the sanctity of *tamlik* (transfer of ownership to the beneficiary) in *zakat*-based microfinance and arrived at the conclusion that the concept of *tamlik* was not disregarded in the method suggested by this study. This is because it is only after *zakat* has been distributed to those who need it most that the microfinance portfolio would be used for those who did not receive based on the priority suggested in light of *hadith* mentioned in this study. Therefore, *tamlik* is protected because the *zakat* money extended to microfinance will come back to the fund. The study proposes that Islamic microfinance instruments should be guided by specific parameters, including interest-free *qard hasan* and other Islamic contracts, which could be implemented through a diverse range of means such as partnership-based agreements like *muḍarabah* and *musharakah*, or debt-based financing mechanisms like *salam* (for agriculture-based businesses), *istiṣna'*, *ijarah*, etc. When repayment of *qard* is made, the *zakat* institution must distribute the capital to another eligible recipient whose rights have been delayed before. For *muḍarabah* in the context of *zakat*-based microfinancing, the '*amil* is regarded as a financier while the *mustahiq* is an entrepreneur to venture into a business they want to venture into. Since *muḍarabah* is based on a profit-sharing system, the '*amil and beneficiaries must share profit and loss as in the agreement. Profit from the acquired business should be distributed to the other *mustahiq*. On the contrary, in the event of a loss, it will be jointly shared between the '*amil and *mustahiq*. At the end, a risk management framework is proposed to protect the *zakat* funds against loss.**

In accordance with the analysis presented by Mahadi (2025), Projek Hassan in Kedah, a consortium involving Lembaga Zakat Negeri Kedah (LZNK), MIFC Leadership Council (MLC) and Association of Islamic Banking and Financial Institutions Malaysia (AIBIM), and INCEIF University, constitutes a critical intervention designed to significantly enhance the efficacy of *zakat* programmes. The central tenet of the project is the strategic re-engineering of *zakat*

disbursement and management, with the express goal of fundamentally advancing the welfare, economic viability, and holistic social inclusion of the *asnaf* populace. This initiative is predicated on social empowerment, ensuring the capital deployed serves as a potent catalyst for sustainable economic transformation, thereby enabling the *asnaf* to migrate from reliance to economic autonomy and active participation in the broader fiscal landscape.

In As Mahadi (2025) discusses, the Malaysian context features benevolent microfinancing initiatives, such as iTEKAD and BangKIT, specifically targeting B40 entrepreneurs for economic empowerment. A distinctive and impactful element within this ecosystem is the strategic deployment of *zakat* funds alongside conventional microfinancing, where a consortium of financial institutions, including four commercial banks (Maybank, Alliance Bank, AmBank, and Public Bank), two Islamic banks (Bank Islam (refer to Figure 1) and Bank Muamalat), and three Development Financial Institutions (DFIs) (Bank Rakyat, Bank Simpanan Nasional, and Agrobank) participate in the *Skim Pembiayaan Mikro* (Microfinancing Scheme) to facilitate and sustain these inclusive financial interventions.

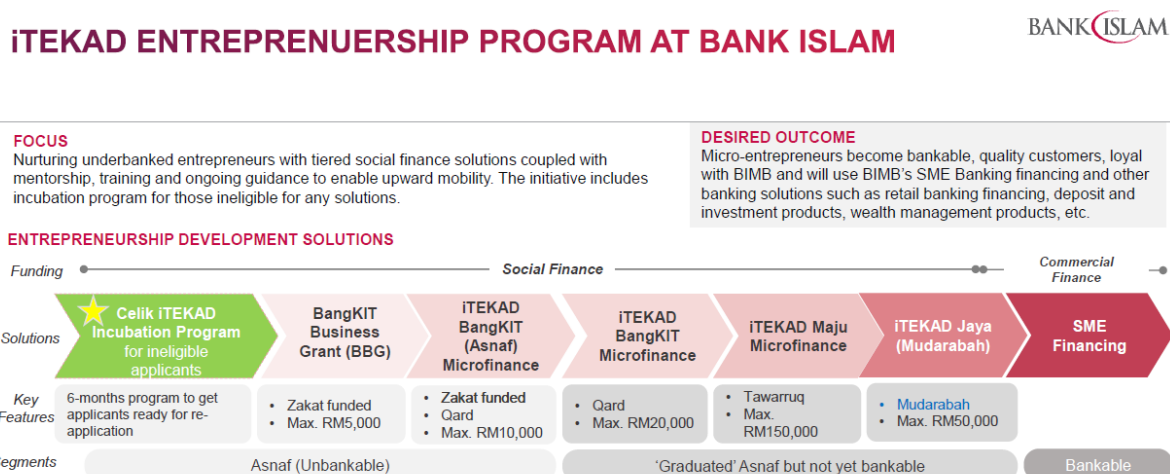


Figure 1: iTekad Entrepreneurship Program of Bank Islam

Source: Bank Islam (2024)

Two levels of justification are provided for this proposal of *zakat*-based microfinance. The first is that the suggested mechanism only strengthens the Shari'ah objectives of *zakat* and does not conflict with them. The second is that, despite the large amounts of *zakat* collected, there are still many poor who lack microcredit for micro enterprises. They currently have little choice but to apply to financial institutions that offer microfinance facilities on a commercial basis that involves *riba* and relatively onerous conditions which many poor people are unable to meet. For example, Maybank's microfinance facility is $1.5 + 8\% = 9.5$ per annum (Maybank2u, 2022) This rate may be bearable to larger registered SMEs, but it is not affordable for the B40. Therefore, instead of allowing the B40 and those who are better off but not wealthy to remain without capital for

microfinance, and not getting enough *zakat* for microenterprises, it would be a *maṣlahah* approved by the Shari'ah to use a portion of *zakat* funds to extend Islamic microfinance facilities to them without onerous conditions. This is because, due to the many beneficiaries, *zakat* is distributed in small amounts, and thus many potential *zakat* beneficiaries still do not receive any.

Hence, this study aims to come up with an applicable *zakat*-based microfinance mechanism so that *zakat* can reach more beneficiaries through *zakat* distribution and employing a portion for microfinance among the *asnaf* that are denied distribution due to the *hadith's* permission to prioritize the most vulnerable as discussed earlier.

Zakat-based Microfinance Risk Management Framework

This study highlights the importance of having risk management practices in *zakat*-based microfinance, underlines the risks associated with the operation of *zakat*-based microfinance, and proposes a risk management framework for it. The main principle of risk management is to achieve the best possible outcome and reduce volatility or uncertainty of outcomes (Hopkin, 2018). ISO 31000 has been unveiled to help manage risks. Its risk management guidelines provide sound principles, a framework, and a process for managing risk as well as for effective management and corporate governance.

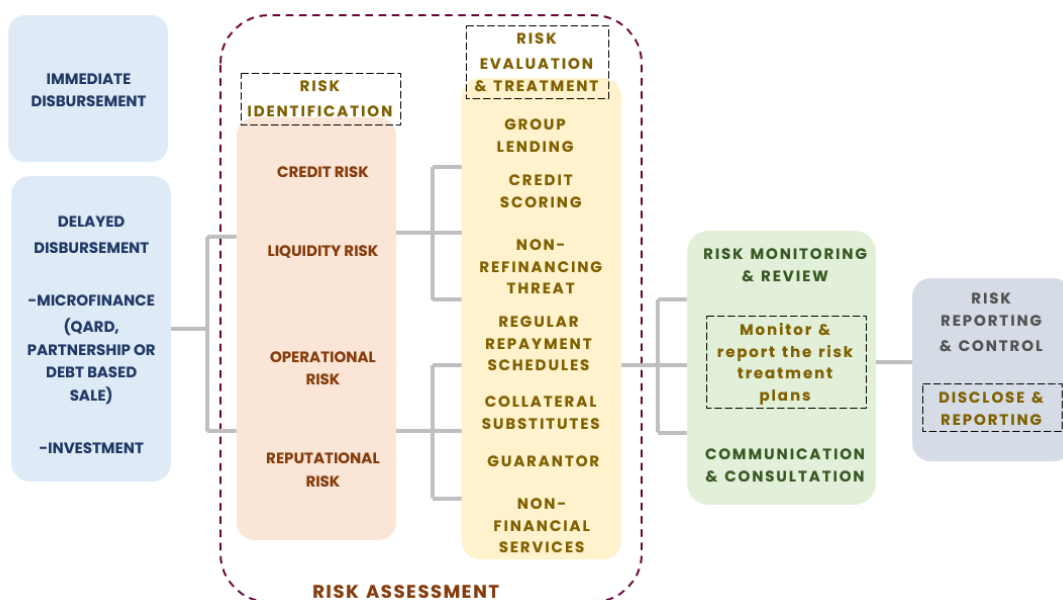


Figure 2: *Zakat*-based Microfinance Risk Management Framework.

Source: Authors (2025)

The *zakat*-based microfinance risk management framework commences by identifying the potential and actual risks i.e., credit, liquidity, operational and reputational risks, and continues by assessing or measuring those risks. After discovering and evaluating the risk, it is

necessary to determine what kind of actions/activities/treatments can be implemented by the *zakat* institution to mitigate these potential risks. Otherwise, this can lead to significant failures for the *zakat* institution. The *zakat* authority (via its Shari'ah committee) must provide justification for applying *zakat*-microfinance among the *asnaf* instead of direct distribution to its beneficiaries. After a decision has been made and implemented by the *zakat* authority, monitoring and review as well as continuous communication with and consultation for the eligible beneficiaries (the borrowers) are required. Reporting and control comprise the last part of the risk management practices. This proposed framework will be further explained subsequently.

Risk Identification in the Zakat-based Microfinance Programme

Zakat-based microfinance is not exempted from risk as any business activity must deal with various types of risks and choose the level of risk it has appetite for. Risks associated with this project are discussed as follows:

1. Credit Risk

Credit risk arises from two sources: financial risk and business risk (Graham & Coyle, 2000). Financial risk is the possibility of non-payment or late payment because of the financial circumstances, principally a lack of liquidity of the beneficiaries. Whilst business risk is the possibility of a credit beneficiaries failing to pay because of circumstances connected with their business activities (setback or downturn) and management (bad decision making). Business risk is called *khaṭar* or *mukhatarah* by Muslim jurists, which is defined as 'the possibility of unexpected outcomes' (Al-Sharbaṣi, 1981). *Khaṭar* and *mukhatarah* are interchangeably used with *gharar* ('Uwayḍah, 2010). According to *Al-Mawsu'ah Al-Fiqhiyyah Al-Kuwaytiyyah* (1983-2006) *mukhatarah* is the doubtful status of a business transaction in which gain, and loss are unknown.

Credit risk could result in insolvency. Total credit given by the *zakat* institution to its eligible beneficiaries is measured by the amount of each credit transaction, the volume of credit transactions, and the length of the credit period. Attestation by the contracting parties in a financial transaction is required to manage risk, particularly credit risk. 'Usmani (1978) explained that, Al-Baqarah, (2:282) indicates that if the trust of the counterparty is insufficient, an effective step must be taken to avoid fraud and unreasonable losses.

In the following Qur'anic verse, attestation by contracting parties in a financial transaction is required to manage risk, particularly the credit risk: 'O you, who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. Let no scribe refuse to write as Allah has taught him. So let him write and let the one who has the obligation dictate. And let him fear Allah, his Lord, and not leave anything out of it....' (Al-Baqarah, 2:282). Attestation is a basic requirement in Islamic commercial law to mitigate the risk of any party denying what was agreed upon. In case of

debt, Shari'ah allows the creditor to receive collateral as the debt security. This is an example of risk management, i.e., mitigating credit risk due to the failure of the debtor in fulfilling his financial obligations.

Limiting the volume of debtors, partially perhaps by reducing the credit period, can prevent the risk. Credit analysis of potential beneficiaries is carried out in order to judge the credit risk of the beneficiaries and to reach a financing decision by *zakat* authorities. Al-Suyuti (1961) said a beneficiary has the right to be given his sufficiency from *zakat*, such as an amount needed to buy equipment, or needed capital, if the person is a businessman. The question here is who shall compensate the amount due in micro financing in case of any destruction or loss? Is it the *zakat* administrator or the respective beneficiaries who should guarantee its recovery in case of any loss? Who holds the responsibility of being *amin* here? This should be properly documented prior to subscription to *zakat*-based microfinance.

2. *Liquidity Risk*

The risk of bad debts, late payments and deliberate delay could also create a liquidity risk for *zakat* institutions that have insufficient *zakat* funds or borrowing capability to finance excessive requests or debtor burdens. With regard to the investment of the *zakat* fund, it must be invested into assets that are beneficial, secure and easily liquidated when the need to distribute to eligible recipients arises (Al-Zuhayli, 1984), in order to overcome liquidity risk.

3. *Operational Risk*

The operational risk process in *zakat*-based microfinance consists of various questions. Are *zakat*-based microfinance management and operational risks adequately monitored in a conscientious manner? Are policies and procedures of the *zakat* authority clearly defined and adequately adhered to?

The *zakat* institution should establish a unique operational framework for *zakat*-based microfinance, as well as a thorough prudential disclosure and reporting apparatus that follows AAOIFI Shari'ah Standard No. 35, item 2/2/4: In case of establishing a *zakat* fund, or preparing *zakat* accounts, clearance by the Shari'ah Board of the institution or the company should be obtained. Clearance by the Shari'ah Board is particularly required for disbursement of the *zakat* funds when performed directly by the institution/company or through an accredited *zakat* agency. Moreover, a comprehensive report on *zakat* disbursements should be presented to the Shari'ah Board on an annual basis.

The *zakat* institution shall have in place adequate systems and controls, including a Shari'ah Board/Advisor, to ensure that *zakat*-based microfinance is extended to its eligible beneficiaries in compliance with Shari'ah rules and principles and in alignment with Islamic Financial Services Board (IFSB) Principle 7.1. In compliance with IFSB Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic

Financial Services, Principle 7.1: IIFS shall have in place adequate systems and controls, including Shari'ah Board/Advisor, to ensure compliance with Shari'ah rules and principles.

The *zakat* institution shall have in place appropriate mechanisms to safeguard the interests of both the *zakat* payers and the *asnaf*. Therefore, the *zakat* institution shall ensure that the bases for *zakat* fund, management and distribution are established, applied and reported in a manner consistent with the *zakat* institution's fiduciary responsibilities and consistent with IFSB Principle 7.2. IFSB (2023) Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services, Principle 7.2: IIFS shall have in place appropriate mechanisms to safeguard the interests of all fund providers.

The *zakat* institution shall establish a comprehensive risk management and reporting process to assess the potential impacts and perceived risks of extending *zakat*-based microfinance to its beneficiaries in order to ensure the *zakat* institution's good reputation, its soundness of operations and reliability of reporting. Furthermore, a policy of investing *zakat* funds by the *zakat* authority in *muḍarabah* and other Shari'ah-compliant investments must avoid high-risk avenues.

4. Reputational Risk

Reputational risk is the risk of potential losses to a *zakat* institution caused by negative perceptions, which could affect its ability to perform well. Inaccuracies, errors and violations in *zakat* management and performance in offering *zakat*-based microfinance could potentially tarnish the *zakat* institution's reputation. Errors in *zakat* distribution could cause *zakat* payers to seek other means to pay their *zakat*, resulting in a decline in the institution's collection of *zakat* funds and jeopardising the rights of the *zakat* beneficiaries (*asnaf*) who depend on it.

Risk Evaluation and Treatment in Zakat-based Microfinance

Risk evaluation and risk treatment entail identifying existing controls or mitigation strategies for the potential risks of *zakat*-based microfinance. Careful thought must be given to how to secure a high repayment rate, mitigate credit risk, and manage adverse selection when the *zakat* institution (the lender) does not require its poor beneficiaries to provide any collateral. These mechanisms include the use of incentive-mechanism group financing, credit scoring, threats of non-refinancing, collateral substitutes, guarantors, regular repayment schedules and the provision of non-financial services.

1. Incentive-Mechanism Group Financing

How can the *zakat* institution manage credit risk and adverse selection when it provides collateral-free loans for both groups and individuals? Poor credit control heightens the risk of liquidity to the *zakat* institution that offers microfinance schemes to poor active beneficiaries. Conventional microfinance has instituted an effective system of credit risk

management for extending financing to groups. The *zakat* institution could likewise apply collateral substitutes through the concept of joint liability whereby repayment of the financing is a shared responsibility of all of the group's members; i.e., each beneficiary is jointly liable for the others' loans and shares the risk. If one defaults or is delinquent, all the group's members face a setback (often in the form of penalties, denial of future credit access, and provisional suspension from the financing). Incentive-mechanism group financing with joint liability controls the problem of adverse selection, and it is an effective credit scoring mechanism. The incentives induced by the joint-liability mechanism in group financing contracts entails that borrowers will share information, and it provides an incentive for peer monitoring and reduces asymmetric information. Recipients would be encouraged or required to participate in groups in order to be entitled to *zakat*-based microfinance. This will help protect the *zakat* institution against unforeseen risks and uncertainties resulting in default and delinquency.

Ghatak (1999), Morduch (1999), Van Tassel (1999) and Zeller (1998) mentioned that borrowers in group lending have impeccable knowledge of their partners, and this mechanism of peer selection and screening among the borrowers and their partners makes the effective cost of borrowing lower to safer borrowers, helps mitigate problems caused by adverse selection and moral hazard and, hence, improves repayment rates and efficiency. The question arises if there is any means for generating high repayment rates from poor borrowers without requiring collateral and without using group financing contracts?

2. Dynamic Incentives

The dynamic incentives mechanism boils down to the threat not to refinance a delinquent borrower or person who defaults on his debt obligations (Ibtissem & Bouri, 2013) by the denial of future credit. The defaulter who has considerable needs for future funding to develop his business would find it difficult to find partners that would be willing to co-sign for future funds or secure financing approval.

Default risk can be gauged by using credit scoring to run a creditworthiness analysis of prospective recipients; e.g., scores given by the Central Credit Reference Information System (CCRIS), and Credit Tip-Off Service Sdn Bhd (CTOS). However, these beneficiaries frequently have no records with credit bureaus, which makes credit scoring difficult in the *zakat*-based microfinance context. The lack of information can lead to inaccurate evaluations and hence to high arrears and default.

Although it is difficult to know exactly who might default or fail to meet contractual obligations, *zakat* authorities can lessen the severity of a loss by creating regular repayment schedules for the beneficiaries (borrowers). This mechanism would allow the *zakat* institution (funder) to develop a long-term relationship with beneficiaries over time and then screen out the worst or undisciplined prospects prior to expanding the micro-credit scheme. The established repayment schedules necessitate that the eligible beneficiaries (the

borrowers) possess a supplemental income stream, given that the repayment obligation commences prior to the investment yielding returns. This prerequisite thereby facilitates a positive selection of suitable beneficiaries for the *zakat* authorities (the lender).

3. Collateral Substitutes

Generally, collateral serves to decrease default risk in instances where borrower's cash flows can be diverted. *Zakat* institutions may accept relevant important documents that may demonstrate their capability to meet the criteria that have been set up by *zakat* institutions as well as tangible assets such as stocks as collateral substitutes in individual financing in *zakat*-based microfinance.

4. Guarantor

Should the *zakat* institution require a guarantor who consents to guarantee the beneficiary's loan under the concept of *kafalah*? The idea here is that the guarantor would act as an *ex ante* indicator and *ex post* sanction mechanism; however, the essential role of a guarantor should be as a decisive factor for granting the credit and not as a secondary repayment source (Ibtissem & Bouri, 2013).

According to Ibtissem & Bouri (2013), a guarantor acts mainly as an *ex ante* signal that can reduce the problem of adverse selection. A guarantor is someone who trusts the potential borrower and is aware of the possible financial risks. However, finding a person who is prepared to perform this role requires a great deal of effort from the potential borrower and is often difficult. Hence, this requirement may prove to be a formidable hurdle for bad borrowers. On the other hand, the involvement of a guarantor is also an *ex post* sanction mechanism. Indeed, in case of default of payment, the guarantor would be legally responsible for paying the debt. Apart from the financial burden, these situations can lead to loss of reputation and could end friendships or cause family feuds. Both the borrower and the guarantor should think seriously about whether they can commit to maintaining the payments.

Credit management is concerned principally with managing debtors and financing debts that will decrease the default risk and increase repayment rates. The amount of credit granted to eligible beneficiaries should be kept under control. The *zakat* institution (management) should be aware of the amount of credit to be disbursed and the potential consequences of over-exposure to any single beneficiary. Policies and procedures must be applied for granting financing to beneficiaries, collecting payment and limiting the risks of non-payment.

5. Restricting Bad Debts

There are various ways to arrange microfinance schemes by a *zakat* institution that functions to extend Shari'ah-compliant financing to the lowest economic segments of the society. What can the *zakat* authority do to minimise bad debts from its beneficiaries on *zakat*-based microfinance?

Providing revolving credit through *qard hasan* loans out of pooled *zakat* proceeds ensures that the fund is automatically replenished every time loans are repaid (Obaidullah, 2008). The outcome would be a sustainable Shari'ah-compliant financial service provider for the beneficiaries. The objective of such a project would be provision of start-up capital to the eligible beneficiaries for microfinancing; the idea would not be to generate maximum returns on investments (Obaidullah, 2008).

6. Non-Financing Services

By offering non-financial services, *zakat* institutions can assist in unlocking the potential of eligible beneficiaries to promote better careers for them, protect the businesses in their portfolio, and eventually solidify the economic recovery, especially post-pandemic. *Zakat* non-financial services include economic activities, financial education, research and development, often in the form of workshops or training in fisheries, aquaculture and agriculture, which are designed to build the knowledge and capacity of the beneficiaries and eventually empower them financially.

Risk Reporting and Control: Appropriate Disclosure and Reporting

The *zakat* institution shall take necessary measures to ensure that management processes are in place for the identification, treatment, monitoring, communication, consultation, disclosure, reporting, and control of the *zakat*-based microfinance. And these elements must be organised in an appropriate structure. The institution should, moreover, ensure that these processes adhere to Shari'ah, and it should consider all associated contingencies when designing them. After a decision to provide microfinancing to the eligible beneficiaries has been made and implemented by the *zakat* authority, monitoring, consulting, and reporting usually take place. This is to ensure the *zakat*-based microfinance is compliance and protect the *zakat* authority from potential and actual risks. Hence, the *zakat* institution shall have in place competent staff to undertake the analysis of risk exposures arising from extending *zakat*-based microfinance to its eligible beneficiaries, and to continuously communicate with them.

CONCLUSION

The *zakat* institution should establish a unique operational framework for *zakat*-based microfinance as well as a thorough prudential, disclosure and reporting apparatus, customised to the special principles and demands of Shari'ah-compliant microfinancing and investment. Successful risk management requires multi-disciplinary collaboration. Will the *zakat* authority think of taking adequate action to mitigate the risks? The *zakat* management personnel must be sufficiently involved with operations to monitor and control the risk and demonstrate adequate commitment, responsibility and competence throughout the project.

Zakat-based microfinance leads to economic empowerment and aims at social transformation of the poor and the realisation of social justice, which will eventually achieve the higher objectives of the Shari'ah. Therefore, *zakat*-based microfinance by the *zakat* institution has to display its sustainability and robustness by having in place an appropriate framework and measurement mechanisms when extending *zakat*-based microfinance to its beneficiaries as well as managing its risks, where applicable. A profound risk management framework is required to maintain the business stability of the *zakat* fund. All proposed parameters must be observed in managing the risk to build a stronger and more resilient *zakat*-based microfinance sector for the future.

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