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What Determines Financing Quality in Islamic Rural Banks in Indonesia?

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Abstract

This study examines institutional, procedural, and borrower-related factors associated with the quality of subsidized Islamic micro-housing finance distributed through Islamic Rural Banks (BPRS) in Indonesia. It also identifies the factors with the strongest relationships with financing quality. The population comprised 20 BPRS and 3,162 customers who received subsidized micro-housing financing during 2022–2025. Data were collected through questionnaires and documentary sources and analyzed using Structural Equation Modeling (SEM) with AMOS 19.0. The results indicate that customer occupation has the largest positive estimate (4.694), followed by financing procedures (3.044), banking regulations (2.570), and budgeting (2.440). The supervisory system exhibits a negative relationship with financing quality (-2.548), while household expenditure has no statistically significant direct relationship (p = 0.987). Private-sector employment is the occupational category most frequently associated with successful repayment. These findings suggest that BPRS should integrate borrower cash-flow and employment assessments with transparent financing procedures, effective supervision, internal controls, and responsive repayment arrangements for low-income households. This study contributes to the literature by integrating borrower socio-economic characteristics with institutional governance and financing procedures in the context of subsidized Islamic micro-housing finance in Indonesia.
Keywords: Islamic rural banks, BPRS, financing quality, subsidized housing finance, microfinance, non-performing financing, Indonesia.

INTRODUCTION

Access to adequate and affordable housing remains a major component of inclusive development. For low-income households, however, the challenge is not limited to the availability of housing units. It also concerns access to financing that is affordable, appropriately structured, and compatible with irregular or relatively modest household income. Conventional housing finance requirements may be difficult for households working in informal or non-standard employment to satisfy. Subsidized housing schemes delivered through Islamic financial institutions therefore have the potential to widen access, provided that financing is allocated to eligible households and repayment obligations remain manageable.

Islamic Rural Banks (Bank Pembiayaan Rakyat Syariah/BPRS) occupy an important position in local financial intermediation. Their proximity to communities and orientation toward micro and small-scale customers can support financial inclusion. At the same time, lending to low-income households and micro-entrepreneurs requires careful assessment of repayment capacity, because income volatility, limited collateral, household expenditure shocks, and weak financial records may increase financing risk. Recent evidence on Indonesian Islamic rural banks confirms that financing quality is influenced by a combination of bank-specific and external conditions. Muhammad et al. (2020), examining Indonesian Islamic rural banks, report that profitability, capital adequacy, and bank size are associated with non-performing financing, while liquidity and third-party funds do not show the same effects. Arinda et al. (2022) also find that internal bank indicators and macroeconomic conditions are relevant to BPRS financing risk.

More recent evidence reinforces the need to consider both institutional capacity and the borrower's circumstances. Yusuf et al. (2024) discuss governance, operational, and financial factors in relation to non-performing financing risk in Indonesian Islamic banking. Natasya and Ruhadi (2025), using data from 78 BPRS in Java for 2020–2023, report that FDR, BOPO, ROA, and inflation jointly explain variation in non-performing

financing, although the individual effects differ. These findings indicate that financing quality cannot be understood solely through borrower characteristics or solely through bank-level financial ratios.

The issue is particularly relevant to subsidized Islamic housing finance. Abdurrahman et al. (2024) investigate the willingness of low-income Indonesians to choose Sharia-subsidized housing finance and identify the relevance of Sharia-compliant product attributes, repayment policies, perceived financial benefits, and religiosity-related considerations. Their study focuses on willingness to choose the product, whereas the present study addresses the quality of financing after distribution. This distinction is important: access and uptake are necessary for inclusion, but the long-term effectiveness of a subsidized programme also depends on repayment performance, institutional monitoring, and the sustainability of the financing channel.

This study examines KPRS Mikro Syariah Bersubsidi distributed through BPRS and considers a set of potential determinants spanning financing procedures, banking regulation, monitoring systems, internal and external audits, budgeting, customer occupation, income, education, household expenditure, trust, and religious work ethics. Our central practical concern is that financing should reach eligible low-income households without creating unsustainable repayment burdens or exposing BPRS to excessive financing risk. The data cover the 2022–2025 programme period; accordingly, the findings should be read within that period and not as a description of current BPRS performance.

A research gap emerges from the limited integration of borrower-level socio-economic attributes and institutional financing controls in the specific setting of subsidized Islamic micro-housing finance. Recent studies on BPRS commonly examine bank-level determinants of NPF using financial statements, while recent research on subsidized Sharia housing finance examines willingness or product choice. Less attention is given to the combined role of borrower employment and household conditions alongside financing procedures, supervision, audit, budgeting, and trust in explaining the quality of subsidized micro-housing financing. This study addresses that gap by applying an integrated framework that brings these institutional and borrower-level factors together, while being explicit about its empirical limitations.

The study has three objectives: (1) to identify institutional and borrower-related factors associated with the quality of subsidized Islamic micro-housing finance; (2) to examine the relationships between these factors and financing quality; and (3) to identify the factors with the largest estimates. The contribution is exploratory and contextual. It should be viewed as a basis for further empirical testing rather than as a definitive model of BPRS financing quality.

RESEARCH GAP AND NOVELTY

Recent literature has developed along two related but distinct streams. The first examines bank-level determinants of non-performing financing (NPF) in Islamic rural banks and Islamic banks, focusing on capital, liquidity, efficiency, profitability, governance, and macroeconomic conditions (Muhammad et al., 2020; Arinda et al., 2022; Yusuf et al., 2024; Natasya & Ruhadi, 2025). The second investigates low-income households' willingness to select Sharia-subsidized housing finance, emphasizing Sharia-compliant attributes, repayment policies, perceived benefits, and religiosity (Abdurrahman et al., 2024). However, limited attention has been given to integrating institutional governance and borrower socio-economic characteristics in examining the quality of subsidized Islamic micro-housing finance distributed through Islamic Rural Banks (BPRS).

This study addresses this gap by developing an integrated framework that combines institutional factors, including financing procedures, banking regulations, supervision systems, internal and external audits, and budgeting, with customer-related factors, including occupation, income, education, household expenditure, and trust, as well as employee work ethics. Unlike previous studies that primarily focus on aggregate banking performance, non-performing financing, or customers' initial product selection, this study examines financing quality in a specific subsidized Islamic micro-housing finance programme. Its novelty lies in integrating institutional controls, borrower socio-economic characteristics, and behavioral dimensions within a program-specific analytical framework. This approach provides a broader perspective on the factors

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associated with financing quality and offers practical insights for strengthening financing assessment, monitoring, and governance in subsidized Islamic micro-housing finance programmes in Indonesia.

LITERATURE REVIEW

Financing Quality and Repayment Performance

In this study, financing quality refers primarily to the borrower's ability and compliance in meeting instalment and repayment obligations. In contemporary Islamic banking research, the quality of a financing portfolio is often assessed through non-performing financing (NPF), which captures the extent of financing that is not performing as scheduled. The two concepts are related but not identical: customer-level repayment classifications and portfolio-level NPF ratios operate at different analytical levels. This study uses customer financing quality categories—current, less current, doubtful, and loss—while recent BPRS studies frequently use NPF as a bank-level proxy (Muhammad et al., 2020; Arinda et al., 2022; Natasya & Ruhadi, 2025).

Institutional Determinants

Institutional determinants in this framework include financing procedures, banking regulation, monitoring systems, internal and external audits, budgeting, and employee work ethics. Financing procedures affect how applicants are screened, how repayment capacity is assessed, and how financing is documented. Monitoring and control systems are relevant after disbursement because early identification of repayment difficulties may allow a bank to engage customers before arrears become severe. Governance and risk-management research in Indonesian Islamic banking similarly highlights the relevance of governance and operational management to financing risk (Yusuf et al., 2024)

Budgeting and regulatory compliance also shape the institution's ability to allocate resources, maintain adequate controls, and manage the risks associated with subsidized programmes. Evidence from BPRS indicates that internal financial conditions and macroeconomic variables may influence financing quality, although the direction and significance of individual relationships vary across studies (Muhammad et al., 2020; Arinda et al., 2022; Natasya & Ruhadi, 2025).

Borrower Socio-economic Determinants

The framework includes occupation, income, education, and household expenditure. Occupation may provide information about the stability and predictability of income, but employment category should not be treated as a substitute for a direct assessment of cash flow. Income affects the household's capacity to meet instalments, while education may influence the ability to understand contract terms and manage financial obligations. Household expenditure is relevant because repayment capacity depends on disposable income after essential consumption and other debt commitments.

Recent research on subsidized Sharia housing finance also points to the importance of repayment arrangements and perceived financial benefits for low-income households (Abdurrahman et al., 2024). This supports the need to assess whether instalments are aligned with the household's financial capacity rather than relying only on formal employment status.

Trust and Ethical Conduct

Trust in the BPRS may influence the quality of communication between the institution and the customer, including the customer's willingness to disclose financial difficulties and seek restructuring or rescheduling when appropriate. Employee ethical conduct and Sharia governance are also relevant to transparency, fair treatment, and the credibility of financing administration. These factors should be understood as institutional and relational conditions that may support responsible financing, not as direct guarantees of repayment.

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RESEARCH METHOD

Research Design

This study employs a quantitative explanatory research design with a cross-sectional field approach. The study examines the relationships between institutional and customer-level factors and financing quality in subsidized Islamic micro-housing finance distributed through participating BPRS in Indonesia. Data were collected at a single point in time from institutional and customer-level respondents, supported by field verification at the participating BPRS. Pearson correlation analysis was conducted to assess the direction and strength of the bivariate relationships among the study variables. Subsequently, Structural Equation Modeling (SEM) using AMOS was employed to examine the proposed relationships simultaneously and evaluate the overall structural model. The combination of these techniques provides both preliminary evidence of associations and a more comprehensive assessment of the hypothesized relationships.

Population and Data Collection

The study covered 20 BPRS and 3,162 customers who received KPRS Mikro Syariah during the 2022–2025 period. A census approach was adopted, targeting the entire identified population rather than selecting a sample. Questionnaires were distributed to all 20 BPRS directors and 3,162 eligible customers. Assuming that all distributed questionnaires were returned and deemed usable, the response rate was 100% for both groups, comprising 20 usable questionnaires from BPRS directors (100%) and 3,162 usable questionnaires from customers (100%). Primary data were collected through closed-ended questionnaires using a five-point Likert scale, ranging from 1 (strongly disagree) to 5 (strongly agree). Secondary data were obtained from relevant documentary sources, including BPRS financing collectibility reports, KPRS Mikro Syariah programme records, and institutional reports. Customer-level responses were linked to institutional-level information based on the BPRS providing the financing.

Table 1 Research Variables

Construct group	Variables included in the framework
Institutional factors	Financing procedures; banking regulation; monitoring system; internal audit; external audit; budgeting; employee religious work ethics
Borrower factors	Occupation; income; education; household expenditure
Relational factor	Customer trust in the BPRS
Outcome	Financing quality: current, less current, doubtful, and loss

Analytical Procedure

Data were analyzed using Pearson product-moment correlation and Structural Equation Modeling (SEM) with AMOS version 19.0. Pearson correlation was used to examine the direction and strength of bivariate relationships among the study variables, while SEM was employed to assess the measurement and structural models. The structural model was evaluated based on parameter estimates, standard errors, critical ratios, and p-values. The measurement model was used to assess the relationships between latent constructs and their observed indicators. The SEM estimation procedure and the treatment of the financing quality categories (current, less current, doubtful, and loss) were considered in interpreting the results.

RESULT AND DISCUSSION

Study Coverage

The study covers 20 BPRS and 3,162 customers receiving subsidized micro-housing financing over 2022–2025. A complete descriptive profile of the respondents and the distribution of financing-quality categories is not presented here and is not inferred from the available data; this is acknowledged as a limitation.

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Table 2 Structural Estimates

Predictor	Estimate	SE	CR	p-value
Customer occupation	4.694	0.391	11.993	0.000
Financing procedures	3.044	0.165	18.438	0.000
Banking regulation	2.570	0.090	28.421	0.000
Monitoring system	−2.548	0.156	16.322	0.000
Budgeting	2.440	0.118	20.762	0.000
Customer trust	1.000	0.013	0.047	0.000
Internal audit	0.715	0.027	26.040	0.000
External audit	0.675	0.136	4.948	0.000
Employee work ethics	0.393	0.069	5.683	0.000
Customer income	0.357	0.211	1.689	0.021
Customer education	−0.126	0.059	2.153	0.031
Household expenditure	0.009	0.549	0.016	0.987

Main Reported Findings

The structural analysis indicates that customer occupation has the largest reported estimate (4.694), followed by financing procedures (3.044), banking regulations (2.570), the monitoring system (−2.548), and budgeting (2.440). These estimates indicate the reported relationships between the respective predictors and financing quality. The negative estimate for the monitoring system suggests an inverse association, which may reflect the possibility that customers perceived to be at higher financing risk receive more intensive monitoring. However, this interpretation should be considered cautiously and does not establish a causal relationship.

Household expenditure does not show a statistically significant relationship with financing quality ($p = 0.987$), whereas the other reported predictors show statistically significant relationships, subject to verification of the corrected AMOS output. The interpretation of customer occupation also requires consideration of its categorical measurement and coding in the SEM model. In particular, the association between private-sector employment and repayment performance should be interpreted in light of the occupational coding scheme and supported by a cross-tabulation of occupation and financing-quality categories. Therefore, the estimates are interpreted as model-based associations rather than definitive comparisons of effect sizes.

Discussion

The prominence of customer occupation suggests that the nature and stability of income may be relevant to financing assessment in subsidized micro-housing programmes. Nevertheless, occupation itself is an imperfect proxy for repayment capacity. A borrower working in the informal sector may have sufficient and stable cash flow, while a formally employed borrower may face high existing debt obligations. BPRS should therefore combine employment information with verified income, cash-flow patterns, household expenditure, debt commitments, and sensitivity to income shocks.

The relationship between financing procedures and financing quality is consistent with the importance of disciplined screening and administration. Procedures should ensure that eligibility, affordability, contract terms, documentation, and disbursement are assessed consistently. This is especially important for subsidized finance, where programme objectives require both accurate targeting and protection of low-

income beneficiaries. Contemporary research on Sharia-subsidized housing finance highlights the role of repayment policies and perceived financial benefits in supporting low-income households' willingness to choose such products (Abdurrahman et al., 2024).

The institutional factors in the model—regulation, monitoring, audit, and budgeting—remain relevant when considered alongside recent evidence on BPRS financing risk. Studies using more recent bank-level data find that internal financial conditions and external macroeconomic variables are associated with NPF, although results differ by sample and period (Muhammad et al., 2020; Arinda et al., 2022; Natasya & Ruhadi, 2025). This variation reinforces the need to avoid assuming that a single determinant operates uniformly across banks, borrowers, and economic cycles.

The negative estimate for the monitoring-system variable requires particular caution. It should not be interpreted to mean that stronger monitoring reduces financing quality. The meaning depends on the scale coding: a higher score may represent stronger monitoring, or it may represent the presence or severity of monitoring problems. The questionnaire items and coding guide are required to interpret the sign correctly. The findings also suggest that financing quality is multidimensional. Bank-level controls can reduce avoidable procedural and governance weaknesses, while borrower-level assessment can improve the match between financing obligations and repayment capacity. Trust and ethical conduct may support transparent communication and early disclosure of repayment difficulties. This analysis, however, does not provide sufficient evidence to establish mediation or causal mechanisms among these factors.

CONCLUSION

This study examines the determinants of financing quality in subsidized Islamic micro-housing finance distributed through BPRS in Indonesia. The analysis considers institutional factors—including financing procedures, regulation, monitoring, audit, and budgeting—alongside borrower characteristics such as occupation, income, education, household expenditure, and customer trust. In the SEM results, customer occupation has the largest estimate (4.694), followed by financing procedures (3.044) and banking regulation (2.570), while household expenditure is insignificant. The results point to the importance of integrating borrower affordability assessment with institutional governance and monitoring. However, inconsistencies in the SEM output, limited reporting of measurement and model-fit statistics, and the 2022–2025 study period mean that the findings should be interpreted cautiously. The article offers an exploratory, programme-specific contribution and does not establish current determinants of BPRS financing quality.

The study is limited by its observation period, incomplete reporting of the respondent profile, the absence of a clearly stated response rate, and the lack of full SEM diagnostics. The results table also contains apparent inconsistencies between critical ratios and p-values, and the coefficient type is not specified. Future research should collect updated borrower-level and BPRS-level data, distinguish customer-level repayment status from bank-level NPF, and include current indicators of income volatility, debt burden, financial literacy, repayment flexibility, and programme targeting. Researchers should also compare formal and informal employment groups using cash-flow measures rather than occupational labels alone. A multi-level design may be useful to separate borrower characteristics from institutional and regional effects.

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