



## The Role of Islamic Financial Institutions in the Development of MSMEs: An Analysis of Financing and Mentoring for Islamic-Based Micro- Enterprises in West Java

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### Article History:

Received: 12-08-2025

Revised: 13-09-2025

Accepted: 29-09-2025

**Keywords:** Business Assistance;  
Islamic Financial Institutions;  
Islamic Contracts; Maqashid  
Syariah; MSME Financing

**Abstract:** MSMEs play a vital role in the Indonesian economy, yet they still face challenges in accessing financing and managing their businesses. Islamic Financial Institutions (IFIs) offer a financing alternative that is not only based on the principles of fairness and profit-sharing, but also prioritizes social sustainability and Sharia compliance. This study aims to analyze the selection and feasibility assessment mechanisms of micro-enterprises implemented by these institutions, as well as to examine the financing and mentoring models implemented to support MSME sustainability. The research method employed a qualitative approach through library research with content analysis of various literature sources related to Islamic financing and MSME empowerment. The results indicate that these institutions implement a selection mechanism based on the Sharia-compliant 5C concept, encompassing character, capacity, capital, business conditions, and collateral, with an emphasis on moral aspects and Sharia compliance. The financing models used include mudharabah, murabahah, ijarah, and qardhul hasan, combined with business mentoring such as management training, Islamic business ethics development, and field monitoring. This integrated approach has been proven to improve financial discipline, business sustainability, and social benefits for MSMEs. Thus, LKS functions not only as a capital provider but also as an agent for empowering the community's economy based on the principles of maqasid sharia.

**How to Cite:** Diana Setiawati, Nayla Putri Aryani, Mozart Tiasylva Syah Nuhandika, Arifkha Gita Zahara, Berliana Azizah, Kanaya Ayodya Indra Prasta, Indah Ayu Dewi Maharani. (2026). The Role of Islamic Financial Institutions in the Development of MSMEs: An Analysis of Financing and Mentoring for Islamic-Based Micro-Enterprises in West Java. *Al Urwah : Sharia Economics Journal*. 2(3). 53-64. <https://doi.org/10.61536/alurwah.v3i2.387>



## Introduction

Micro, Small, and Medium Enterprises (MSMEs) are a key pillar of the Indonesian economy. According to data from the Ministry of Cooperatives and SMEs (2023), the MSME sector contributes more than 60% to the national Gross Domestic Product (GDP) and contributes to employment, accounting for approximately 97% of Indonesia's total workforce. (Yolanda & Hasanah, 2024) This demonstrates that MSMEs play a strategic role in supporting national economic growth, income equality, and poverty alleviation in various regions.

Law of the Republic of Indonesia Number 20 of 2008 which regulates MSMEs states that micro businesses are productive businesses owned by individuals and/or individual business entities that meet the criteria for micro businesses as stipulated in the law. While small businesses are productive economic businesses that stand alone and are carried out by individuals or business entities that are not subsidiaries or branches of companies owned, controlled, or are part of either directly or indirectly of medium-sized businesses or large businesses, and meet the criteria for small businesses as stipulated in this law.

The realization of KUR distribution in West Java from January 1 to May 29, 2024, reached IDR 10.88 trillion with a total of 185,568 debtors. Bandung Regency was the region with the highest distribution and number of debtors, namely IDR 888 billion (8.17%) and 14,828 debtors. In terms of distribution, Bank BRI dominated with a realization of IDR 6.45 trillion (59.27%) and 141,910 debtors (76.47%). The total distribution of KUR through Islamic banks was IDR 813 billion (7.48%) with 15,039 debtors. Based on the scheme, KUR Mikro was the largest with a distribution of IDR 6.96 trillion (64%) and 162,942 debtors (87.81%). The wholesale and retail trade sector dominated KUR distribution, with Rp 6.16 trillion (56.62%) and 103,882 borrowers (55.98%). However, local government participation in uploading potential borrower data to the SIKP application still needs to be improved. As of May 29, 2024, only 674 prospective borrower data had been uploaded.

Despite their vital role, MSMEs still face a variety of complex obstacles, particularly in terms of access to formal financing sources. Limited collateral, small business scale, low managerial skills, and a lack of well-organized financial reporting are often key barriers for micro-businesses in obtaining loans from conventional financial institutions. Furthermore, low levels of financial literacy and sharia-compliant practices among MSMEs contribute to their inability to understand and utilize available financial products (Tambunan, 2021).

In this context, Islamic financial institutions (IFIs) have emerged as an alternative solution that not only offers fair-based financing but is also based on Islamic principles that reject *riba* (usury), *gharar* (uncertainty), and *maysir* (speculation). Islamic financial institutions aim not only to seek profit but also have a social mission to promote economic equality through a mutually beneficial partnership system between institutions and business actors. (Budiono, 2017) The main principle used in the Islamic financial system is profit and loss sharing, which prioritizes fairness, transparency, and shared responsibility.

In addition to providing funds, Islamic financial institutions also serve as agents of economic empowerment for the community. Through financing models such as *mudharabah* (profit-sharing partnerships), *musyarakah* (capital partnerships), *murabahah* (purchase and sale with a profit margin), and *qardhul hasan* (benevolent loans), Islamic financial institutions



can tailor financing products to the specific characteristics and needs of micro-enterprises. (Tantika, 2019) In practice, Islamic financing is often accompanied by business mentoring, management training, and regular monitoring to ensure MSMEs manage their funds effectively and in accordance with Islamic principles.

The West Java government implemented several policies and strategic initiatives to support MSME development between 2020 and 2025. The West Java MSME Champion program provides training, mentoring, financing, and legal facilitation to thousands of MSMEs to increase their competitiveness. The goal of One Pesantren One Product (OPOP) is to create a self-sufficient Islamic boarding school economy through the production, distribution, and sales of typical Islamic boarding school products. Furthermore, Online Funding (Panon Jabar) facilitates MSMEs' digital access to working capital, particularly for government procurement of goods and services. The Blanjakeun program facilitates the marketing of MSME products with shipping subsidies, thereby increasing sales turnover. The government also launched the Kabayan application for MSME financing consultations, which simplifies the administration and access to capital, providing digital solutions for the financing needs of small and medium enterprises in West Java with a more efficient and affordable process.

The involvement of Islamic financial institutions in supporting the MSME sector is expected to create a more equitable and sustainable economic ecosystem. This aligns with the spirit of the maqasid sharia, namely safeguarding assets (hifz al-mal), strengthening social welfare, and avoiding exploitative economic practices. Within the framework of national development, the contribution of Islamic financial institutions to MSME financing also has important implications for financial inclusion, as it can reach groups previously underserved by the conventional banking system (the unbankable sector).

Thus, the urgency of this research lies in the importance of understanding how Islamic financial institutions select and assess the feasibility of micro-enterprises before disbursing financing, as well as how financing and mentoring models are implemented to ensure they adhere to Islamic principles and promote business sustainability. This study is expected to provide theoretical and practical contributions to the development of an inclusive, equitable, and community-oriented Islamic financing system.

The problem formulation in this research focuses on the selection mechanism and assessment of the feasibility of micro-enterprises carried out by Islamic financial institutions before distributing financing, as well as the financing and mentoring models applied to MSMEs so that they remain in accordance with Islamic principles and are able to support the sustainability and development of sustainable businesses.

## Research Methods

This study uses a qualitative approach with a library research method which aims to gain an in-depth understanding of the selection mechanisms, feasibility assessments, and financing and mentoring models applied by Islamic financial institutions to micro-enterprises. (Putri, et al., 2023) The data used in this study is secondary data, namely data

sourced from various scientific literature such as national and international journals, Islamic economics textbooks, official reports from financial institutions, and publications from the Ministry of Cooperatives and SMEs of the Republic of Indonesia. Data analysis was conducted using the Content analysis, which examines, categorizes, and interprets key concepts related to Islamic financing and MSME empowerment. This approach allows researchers to explore the alignment between theory and practice in the context of Islamic financial institutions in Indonesia. All data is then synthesized descriptively and analytically to address two main research questions: selection mechanisms and feasibility assessments, and Islamic-based financing and mentoring models that support the sustainability of micro-enterprises.

## Results and Discussion

### Selection and Assessment Mechanism for Micro-Business Feasibility by Islamic Financial Institutions

Islamic Financial Institutions (IFIs) have a unique approach to selecting and assessing the feasibility of micro-enterprises that differs from conventional financial institutions. This is because the Islamic financing system is not solely focused on profitability but also emphasizes the principles of justice, social sustainability, and compliance with Islamic law. Therefore, IFIs implement an evaluation mechanism that encompasses the financial, moral, social, and spiritual aspects of prospective customers. (Sari, 2020) The main principles of the Sharia financing mechanism are based on the values of justice (al-'adl), openness (transparency), partnership (syirkah), and social responsibility (mas'uliyah ijtimaiyyah). Therefore, the selection process carried out by LKS not only ensures the economic feasibility of the business but also ensures that the disbursed funds are truly used for activities that are halal (lawful), productive, and provide benefits to the wider community (Antonio, 2019). The next stage is business feasibility analysis, which covers several fundamental aspects. This analysis adopts the 5C concept that has been modified in the context of Islamic finance, namely (Ardyanti, 2021):

#### 1. Character

In Islamic finance, the character and morals of prospective customers are paramount. Character assessments are conducted through in-depth interviews, social surveys, and recommendations from community leaders, mosque administrators, or local religious institutions. Honesty (ṣidq), trustworthiness, and responsibility are key indicators in assessing the character of potential financing recipients. This is because profit-sharing systems like mudharabah and musyarakah rely heavily on the trust and integrity of business partners.

#### 2. Capacity (Business Capacity)

Capacity assesses a potential customer's ability to run and develop their business. LKS analyzes the experience, skills, and business strategies of potential loan recipients. In the context of micro-enterprises, capacity is also assessed based on the extent to which the business owner understands the production cycle, marketing, and simple financial



management. This analysis is conducted to ensure that the financing provided can generate sustainable profits and is not solely for consumption (Rahman, 2022).

### 3. Capital (Own Capital)

The personal capital aspect indicates the level of commitment of the prospective recipient to their business. From a sharia perspective, invested personal capital is evidence of sincerity (niyyah ṣādiqah) and a form of responsibility for the funds entrusted to them by the institution. LKS generally give preference to entrepreneurs who contribute personal capital, as this signifies direct involvement in bearing the risks and rewards of the business.

### 4. Condition (Business and Market Conditions)

Assessment of business and market conditions includes analysis of business prospects, product competitiveness, business location, and macroeconomic trends. LKS uses a sharia market analysis approach, assessing business potential not only in terms of financial returns but also in terms of benefits (maslahah) and environmental sustainability. Thus, financing can be directed to sectors with the potential to improve community welfare, such as agriculture, the halal industry, and sharia-based creative MSMEs (Yuliana, 2023).

### 5. Collateral

In the Sharia system, collateral is not a primary factor in financing decisions. However, collateral is still used as a form of risk mitigation against the possibility of default. Uniquely, in Sharia financial institutions, the primary collateral is not only physical assets, but also the moral reputation and discipline of prospective customers. Thus, this approach is more humane and less burdensome for micro-entrepreneurs with limited assets.

The first stage in the selection process is an administrative examination, which includes verifying the prospective customer's identity, business legality documents, and the business's compliance with Sharia principles. LKS conducts an initial screening to ensure that prospective loan recipients are not involved in prohibited business sectors such as the alcohol industry, gambling, prostitution, or speculative activities. This stage is known as negative screening, where businesses that do not comply with Sharia are immediately declared unfit for financing. Furthermore, during this pre-selection stage, LKS also assesses the motivation (intention) and purpose of the loan application. The principle of niyyah (benefit) in Islam plays a crucial role because every good deed is judged based on its intention. Therefore, prospective customers with good intentions and clear business goals, such as developing a family business or creating new jobs, will receive a higher score in the initial selection process. (Hosen & Muhari, 2020).

After a prospective customer passes the feasibility analysis stage, the LKS will conduct a field survey to verify the data and information provided. Field officers, or financing officers, will visit the business location, observe the production process, and assess the social interactions between the business owner and the surrounding community. In this context, aspects of ukhuwah (brotherhood) and social responsibility are crucial considerations, as the LKS not only distributes financing for individual profit but also to promote the well-being of

the local community. The social survey also serves as a form of community-based assessment, where local community opinion can serve as an indicator of morality and social trust in potential loan recipients. This differs from conventional systems, which are primarily focused on numbers and financial ratios.

The final stage of the selection process is determining a financing contract that aligns with the characteristics of the prospective customer's business. Sharia compliance principles are the primary basis for contract selection. For example, a mudharabah contract (profit-sharing between the capital owner and the manager) is used for productive businesses requiring working capital without collateral, while a musyarakah contract (capital cooperation) is suitable for existing businesses seeking to expand capacity. Meanwhile, a murabahah contract is used for financing based on the purchase of capital goods or raw materials, where the LKS purchases the goods first and resells them to the customer with an agreed margin (Ismail, 2022). LKS also ensures that each contract is based on the principles of transparency and willingness (antaradhin) to avoid gharar or uncertainty. With a clear and transparent contract system, the relationship between the institution and the customer can be forged in a fair and mutually beneficial partnership.

This moral, social, and spiritual-based selection and assessment mechanism makes LKS superior in building long-term relationships with its clients. In addition to reducing the risk of non-performing financing, this system also creates a just economic ecosystem oriented toward community welfare. This approach aligns with the objectives of the maqasid sharia, namely safeguarding wealth (hifz al-mal), life (hifz al-nafs), and the public welfare (maslahah 'ammah). Thus, Islamic financial institutions serve not only as capital providers but also as moral and social partners for micro-entrepreneurs. This comprehensive selection process ensures that financing funds are truly channeled to worthy, responsible parties capable of sustainably developing their businesses in accordance with Islamic principles.

### **Financing and Mentoring Models by Islamic Financial Institutions for MSMEs**

The financing model applied by Islamic Financial Institutions (LKS) to Micro, Small, and Medium Enterprises (MSMEs) is fundamentally based on the principles of partnership (syirkah) and economic justice (al-'adl al-iqtishadi). This system is oriented towards risk and profit sharing, unlike the fixed interest system applied by conventional financial institutions. This sharia approach makes LKS not only a fund channeling institution, but also a business partner and moral guide for MSME actors (Antonio, 2019). Furthermore, Islamic financing contains an element of blessing (barakah), because it does not only pursue material profit but also pays attention to the values of social welfare (maslahah) and economic spirituality. Therefore, the financing model used by LKS always emphasizes the principles of honesty, justice, responsibility, and balance between individual and societal interests. In general, there are several contract models that LKS often applies to MSMEs, namely mudharabah, musyarakah, murabahah, ijarah, and qardhul hasan.

#### **1. Mudharabah (Profit Sharing) Contract**

A mudharabah contract is a form of collaboration between a capital owner (shahibul maal) and a business manager (mudharib). In this system, the Islamic financial institution provides the funds as capital, while the customer manages the business independently. Profits are shared according to a ratio (nisbah) agreed upon at the outset of the contract,



while losses are borne by the capital owner as long as they are not caused by the manager's negligence (Sari, 2020).

This contract is particularly suitable for micro-enterprises that lack substantial assets but possess strong business capabilities and ideas. This system fosters trust, transparency, and moral responsibility between the institution and its customers. In practice, Bank Syariah Indonesia (BSI) uses the *mudharabah muqayyadah* contract, where financing comes from specific investors and is channeled to MSMEs in predetermined business sectors, such as the halal culinary sector or local crafts. One of the advantages of *mudharabah* is its flexibility: customers are not burdened with fixed installments but instead share profits based on actual income. This model reduces financial stress and creates a fairer business climate. However, this contract also demands a high level of honesty from business managers, as the LKS is not directly involved in business operations. Therefore, before financing is realized, the institution will thoroughly assess the character and integrity of prospective managers.

## 2. Musyarakah Contract (Capital Partnership)

The *musyarakah* contract is a form of cooperation in which both parties, the LKS (Islamic financial institution) and the customer, contribute capital and business management. Profits are shared according to the agreement, while losses are borne based on each party's proportionate capital contribution (Ardyanti, 2021). This financing model is more suitable for existing businesses that require additional capital to expand capacity or scale production. In the context of MSMEs, the *musyarakah* contract reflects the principles of active participation and shared risk, rather than the hierarchical creditor-debtor relationship found in conventional institutions. For example, BMT UGT Sidogiri in East Java applies the *musyarakah* contract to finance a batik artisan group.

BMTs invest 60% of the capital, while business groups cover 40%. Business management is carried out jointly, and profits are shared at a 70:30 ratio. This system not only increases production scale but also fosters a sense of ownership and shared responsibility between the institution and the business owner. Furthermore, *musharakah* is also used by BSI in its BSI Mitra MSME program, where financing is accompanied by business digitalization training programs and access to online markets. This approach strengthens the position of MSMEs in the economic value chain and expands the market for local products to the national level.

## 3. Murabahah Contract (Buying and Selling with Profit Margin)

Contract *Murabahah* is one of the most popular financing models in Islamic financial institutions (LKS). In this contract, the institution purchases goods needed by the customer (such as raw materials, machinery, or operational vehicles) and then resells them to the customer with a pre-agreed profit margin (Ismail, 2022). This model is considered simpler and easier to monitor, making it widely used for financing the micro-trade, agriculture, and service sectors. The advantage of *murabahah* is the transparency of prices and profit margins, eliminating elements of uncertainty (*gharar*) or speculation (*maysir*). For example, BMT Al-Falah in Surakarta distributes *murabahah* financing to traditional

market traders to procure merchandise. Customers purchase goods from suppliers with capital assistance from the BMT and then repay them in installments as agreed. This approach has been proven to help small traders increase their turnover without being entangled in loan interest.

#### 4. Qardhul Hasan Agreement (Benevolent Loan)

The Qardhul Hasan contract is social and non-commercial in nature. Under this contract, the institution provides loans without compensation to customers in need, especially micro-entrepreneurs affected by disasters, economic crises, or experiencing limited working capital. This financing is oriented towards social solidarity (ta'awun) and economic empowerment of the community, rather than achieving financial gain. For example, the Alms Institution and the Sidogiri BMT (Islamic Zakat Foundation) run the Productive Qardhul Hasan program, where small businesses are provided with capital loans of up to IDR 3,000,000 without margin. Repayments are made flexibly according to the customer's ability. This program has been proven to increase public trust and strengthen the image of Islamic financial institutions as social institutions committed to the welfare of the community (Nafisah, 2021).

In addition to financing, Islamic financial institutions also provide mentoring and business empowerment. Mentoring is a crucial element in ensuring the success and sustainability of financing. These mentoring programs include:

- a. Business management and financial literacy training, so that MSMEs are able to manage capital, record cash flow, and carry out financial planning.
- b. Islamic business ethics guidance, which emphasizes honesty, responsibility, and the prohibition of fraudulent or exploitative practices.
- c. Periodic business monitoring, to ensure that financing is used according to its purpose and does not deviate from sharia contracts.
- d. Empowerment of business groups (joint responsibility), where business actors help each other and guarantee each other, thereby strengthening solidarity and reducing the risk of default.

This assistance also reflects the concept of *maslahah* (maslahah) in Islamic economics, where the goal of financing is not solely to pursue profit, but also to improve social welfare and the economic independence of the community. Through integrated financing and assistance programs, LKS becomes not only a financial institution but also an agent of economic development for the community.

The study results show that implementing a Sharia-based financing and mentoring model can improve the sustainability of MSMEs. Businesses receiving Sharia-compliant financing and mentoring tend to have better repayment rates, maintain financial discipline, and have a long-term focus on business growth (Nafisah, 2021). This demonstrates that Sharia values such as fairness, partnership, and social responsibility can form the foundation of a sustainable economy.

Thus, the financing and mentoring model implemented by Islamic financial institutions serves not only as an economic instrument but also as a means of empowering and strengthening the character of micro-entrepreneurs. This approach aligns with the primary



objectives (maqasid sharia) of safeguarding wealth (hifz al-mal), improving the welfare of the community, and creating a just and sustainable economic system.

LKS plays a strategic role in strengthening the growth of MSMEs by providing financing based on the values of justice, partnership, and social responsibility in accordance with sharia principles. The financing selection process not only assesses financial aspects but also considers moral, social, and business compliance with sharia. By implementing the sharia-compliant 5C concept, LKS can comprehensively assess potential recipients. Administrative stages, field surveys, and social checks ensure financing is provided to halal and productive businesses. Various contracts such as mudharabah, musyarakah, murabahah, ijarah, and qardhul hasan are selected based on business needs while avoiding usury, gharar, and maysir. In addition to providing capital, LKS also provides guidance such as financial training, Islamic business ethics, and regular monitoring. Empowerment programs such as joint liability strengthen solidarity among business actors. Thus, LKS not only provides economic benefits but also shapes the character of Islamic and sustainable businesses, and supports the achievement of the maqasid sharia, especially in safeguarding assets and improving community welfare.

### **Sustainability Elements in the Financing and Mentoring Model of Islamic Financial Institutions for MSMEs**

The financing and mentoring model implemented by Islamic financial institutions (IFIs) for MSMEs is essentially aimed not only at providing access to capital but also at creating sustainable businesses that are economically, socially, and spiritually sustainable. Sustainability, from this perspective, is understood as the ability of MSMEs to maintain their existence and develop their businesses in the long term while adhering to sharia principles. Therefore, the concept of Islamic financing emphasizes not only profitability but also integrates the values of distributive justice, empowerment, and welfare as part of the business development process.

Conceptually, sustainability in the Islamic economy is built through a financing mechanism oriented toward profit and loss sharing rather than a fixed interest rate system (interest-based system). This pattern creates healthier business development because risks are not solely borne by MSMEs but are shared proportionally between the institution and the customer. This risk sharing is crucial to ensuring business sustainability, particularly in the micro-sector, which is vulnerable to income fluctuations, defaults, and market volatility. Eliminating the practices of usury, gharar, and maysir also has sustainability implications, as it eliminates the risk factors of moral hazard and financial exploitation that commonly cause small business stagnation.

Furthermore, LKS plays an active role in ensuring sustainability through systematic mentoring, not just providing funding. This mentoring includes training in management, financial literacy, business ethics, and periodic business monitoring and evaluation. This mentoring is a long-term intervention strategy aimed at improving the capacity (capacity building), competency, and business behavior of entrepreneurs, so that the businesses they manage can develop independently without relying on financial institutions.

On the other hand, social sustainability is built through collective empowerment strategies such as joint responsibility groups and the formation of business networks. This approach fosters social solidarity, positive interdependence, and knowledge exchange among MSMEs. Furthermore, this approach also reduces the risk of default due to the moral and financial support among group members. In this context, sustainability is understood not only as individual survival but also as the economic resilience of the community.

The element of sustainability is also reflected in the LKS's orientation toward business sectors deemed beneficial (*maslahah*) and long-term sustainability. Through a selection process and feasibility analysis that assesses integrity, capacity, capital, business conditions, and collateral, the LKS strives to ensure that funds are directed to businesses that are *halal*, productive, and have the potential for growth. This policy indirectly serves to avoid allocating capital to high-risk, destructive, or non-value-added sectors, which could hamper broader economic sustainability.

Furthermore, sustainability in Islamic financing is realized through the orientation of the *maqasid sharia*, namely safeguarding wealth (*hifz al-mal*), preserving life, preserving reason, and strengthening public welfare. This principle positions capital as a trust that must be managed to achieve individual and collective well-being, not simply as an instrument of financial transactions. Therefore, financing directed at strengthening micro-enterprises is fundamentally part of a long-term socio-economic transformation aimed at reducing inequality, combating poverty, and expanding economic opportunities.

In this context, sustainability is not seen solely as an end result, but as an integrated process across all stages of financing, from the selection of potential recipients and the establishment of contracts and capital disbursement to the monitoring and evaluation of results. This integrative approach differentiates Islamic financing from conventional models, which tend to focus on institutional profits and loan repayment without considering the long-term impact on business actors.

Empirical findings indicate that MSMEs receiving Sharia-compliant financing and mentoring exhibit higher levels of financial discipline, more mature business planning, and a long-term growth orientation. This demonstrates that the Sharia-compliant financing model plays a crucial role in fostering a resilient, adaptive, and competitive business mindset. The Sharia-compliant system also fosters trustworthiness, honesty, and responsibility, essential social capital for the sustainability of micro-enterprises.

Thus, the sustainability element in this problem formulation lies in how the LKS financing and mentoring model not only generates profit but also fosters behavioral transformation, economic stability, and social welfare. This emphasizes the LKS's role as a strategic partner, facilitating the strengthening of an economic structure based on values, ethics, and community empowerment, toward a competitive, independent, and sustainable MSME ecosystem.

## Conclusion and Recommendation

Based on the above discussion, it can be concluded that Islamic financial institutions (IFIs) play a crucial role in supporting the sustainability of MSMEs through a financing system that is not solely profit-oriented but also emphasizes the values of justice, partnership,

and social responsibility in accordance with sharia principles. The implementation of business feasibility screening based on the 5Cs of sharia, the selection of appropriate contracts, and ongoing business mentoring enable these institutions to create both economic and moral impacts for MSMEs. This financing model has been proven to encourage halal, productive businesses and contribute to community welfare. Therefore, it is recommended that Islamic financial institutions continue to improve the quality of their mentoring, strengthen Islamic financial literacy for MSMEs, and optimize the use of digital technology in the financing process and business monitoring. Furthermore, synergy between Islamic financial institutions, the government, and the community needs to be strengthened so that the Islamic financial ecosystem becomes more inclusive, competitive, and able to become a pillar of sustainable and equitable national economic development.

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