

The hidden challenges behind Islamic banking financing: A guide to understanding preventive mechanisms - A case study of Jordan Islamic Bank –

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Abstract: *Islamic banking has experienced remarkable growth over the past few decades, becoming an important financial sector that extends beyond the Islamic world to global markets. The industry has attracted the attention of investors and consumers seeking ethical financing alternatives that comply with Islamic law. However, behind this apparent success and the famous principle of ‘profit and loss sharing’ lies a complex set of hidden challenges facing Islamic banking finance. These challenges not only undermine the efficiency and effectiveness of this sector, but also threaten its philosophical and purposeful essence that distinguishes it from the traditional financial system. In this context, the case study of Jordan Islamic Bank stands out as a rich source of analysis. Studying this case provides a valuable opportunity to understand how these hidden challenges translate into reality in an economy with distinctive characteristics, where the bank operates in a legislative and economic environment dominated by the conventional financial system. This study highlights these hidden challenges facing Islamic banking, using the experience of the Jordan Islamic Bank as a practical example, in an effort to provide a clear vision of the future of Islamic finance and how to transform these challenges into opportunities for sustainable growth.*

Keywords: *Islamic finance, Islamic banking, challenges of Islamic finance, Islamic banking liquidity, Jordan Islamic Bank.*

Introduction:

Islamic banks adhere to the provisions and objectives of Islamic law, which makes them different from their traditional counterparts, whose operating system is based on usury, which was not acceptable to Muslim peoples. Despite this, the role played by riba-based banks in financing individuals and economic units and supporting development projects cannot be denied, not to mention the effective role they play in providing services and facilities, in addition to granting interest-bearing loans.

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It is well known that Islam prohibits usury and monopoly, forbids the hoarding of money, and imposes severe penalties on all suspicious transactions. In order to comply with the provisions of Islamic law on the one hand and keep pace with the wheel of development on the other, and through the efforts of many economic thinkers, the idea of Islamic banks emerged. These banks have quickly achieved remarkable success in the Arab world and globally, especially after their resilience in the face of the global crisis that led to the bankruptcy of many banks. This prompted several countries to resort to Islamic finance due to its characteristics, such as its ability to improve market discipline in addition to the multiplicity and diversity of its financing methods compared to financing in traditional banks.

Despite the success achieved by Islamic banks, they are exposed to many risks, just like conventional banks, if not more. This has led to the need to manage these risks or, in other words, to find new methods and ways to combat these risks, given that Islamic banks are different in nature and follow the objectives of Islamic Sharia.

The main issue of the study:

In light of the above, the following key question can be posed:

How do Islamic banks manage the financing risks they face?

Study hypotheses:

To answer the question posed, the following hypotheses can be used:

* Islamic banks are considered to be of a special nature, using financing methods that differ from their traditional counterparts.

* Islamic banks are exposed to two types of risk: general risks and risks associated with Islamic financing formulas.

Importance of the study:

The importance of this research lies in its discussion of one of the most important issues affecting Islamic banking and hindering its activity, namely financing risks and how to manage them by adopting strategies that will reduce losses and preserve its integrity and continuity.

Study objectives:

These are:

- Highlighting the various financing risks faced by Islamic banks.

- Identifying the most important steps and methods taken by Islamic banking in managing financing risks.

Tools and study methodology:

To conduct the study, we used descriptive and analytical methods, as they are appropriate for the research topic. We relied on the descriptive method to study the theoretical aspects of the research in scientific literature and the analytical method to apply the study to the reality of financing at the Jordan Islamic Bank.

The first axis: Mechanisms of Islamic banks

Islamic banks cannot perform their functions without pooling financial resources, as the latter are of great importance, nor can they carry out their activities without being subject to multiple forms of supervision of a special nature.

Section I: Sources of Funds in Islamic Banks

Islamic banks are based on profit and loss sharing for the sources and uses of funds. The sources of funds in Islamic banks are divided into internal and external sources as follows:

First: Internal sources

These sources are divided into:

1- Paid-up capital: Paid-up capital is the most important internal or intrinsic resource of an Islamic bank and constitutes a fundamental part of its total resources. Paid-up capital

represents the funds collected from the bank's founders at the time of its establishment, as well as any future additions or reductions. It should be noted that shareholders in Islamic banks do not participate in management and are not liable for any obligations beyond their shareholdings. The funds they pay become the property of the company, which has a financial liability separate from their own. Therefore, it is not permissible to differentiate between shares. Paid-up capital plays a fundamental role in the establishment of the bank by providing all the initial requirements necessary for the bank to start operating. It also plays a financing role in the banking market to cover the financing needs of the bank's customers, whether short-term, long-term, or medium-term (Haider, 2011, pp. 36–37).

2- Precautions: The bank allocates various types of secondary reserves from its profits to strengthen its capital, support its financial position, and build a good reputation for the bank. The accumulation of these profits indicates the bank's success and excellence in its work.

There is a special reserve (optional) that the bank relies on in the future to cover future expenses such as the depreciation of buildings, furniture, and machinery.

And also a reserve (emergency) to offset dividend distributions.

3- Retained earnings: It is transferred for financial and economic purposes within property rights.

4- Allocations: Part of it is retained to cover shortfalls in assets or declines in the value of securities. The bank may obtain additional financial resources such as loans from shareholders and insurance deposits from customers as collateral for open credits, or as collateral for letters of guarantee and insurance for rented safes (Sadiq, 2008, p. 42).

Second: External sources

Its main source is deposits in various forms, which can be divided as follows:

1- Current deposits (on demand): These take the form of current accounts where depositors deposit funds without receiving interest, and can be withdrawn at any time without the depositor authorizing the bank to invest them. However, Islamic banks use a limited percentage of these deposits, adding them to their funds earmarked for investment and providing sufficient liquidity to meet withdrawals. The importance of this type of deposit for Islamic banks in terms of investing them is declining. Some call them deposits without investment authorization, as Islamic banks consider these current deposits to be interest-free loans provided by the customer to the bank, which contributes to a certain extent to solving its liquidity problem (Rais, Hada, 2009, p. 233).

2- Savings deposits: They are sometimes referred to as joint investment accounts. As Islamic banks accept cash savings deposits from depositors for investment purposes and sign a mudaraba contract with them. In this case, the bank is the mudarib (investor) and the depositors are the malik (owners of the capital). The mudaraba may be absolute, as in general investment accounts or joint investment accounts, in which case the depositors' funds participate in the net overall results of the investment operations. The depositors receive savings passbooks, as the Islamic bank gives each depositor in these accounts their own savings passbook. Under this service, the Islamic bank obtains authorization from the customer to invest and operate their funds and speculate with them, and the customer receives a variable return proportional to the amount of the deposit and the duration of the investment.

3- Investment deposits: Islamic banks accept cash deposits from depositors for the purpose of investing in a specific project or for a specific purpose. Under this arrangement, the bank signs a restricted mudaraba contract whereby the bank is the mudarib (investor) and the depositors in the dedicated investment accounts are the malik (owners of the capital). The bank operates these investment deposits in accordance with

the agreement and on the guarantee of their owners, who bear the investment risks that may occur during the investment period of the project. In the event of a profit, it is distributed between the depositors and the bank according to the ratios determined in advance when the dedicated investment account is opened, provided that the Islamic bank does not default or violate the agreement (Haider, 2011, pp. 41–42).

4- Investment instruments: They are the legitimate alternative to investment certificates and bonds, and are considered an application of the *mudaraba* formula, whereby the money comes from the *sukuk* holders and the work comes from the bank. *Sukuk* may be unrestricted or restricted, depending on the type of instrument, and the distribution of *sukuk* profits is governed by the rule of “*ghanam bi gharm*” (profit and loss sharing).

5- Islamic savings accounts: Islamic savings accounts are a type of savings deposit offered by Islamic banks. Deposits and withdrawals can be made at any time, and returns are paid annually based on the banks' actual performance. Quarterly returns may also be paid as part of the final return at the end of the year (Naim, 2012, pp. 164-165).

6- Deposits of Islamic financial institutions: Based on the principle of cooperation between Islamic banks, banks with surplus funds deposit those funds in Islamic banks suffering from a cash deficit, either in the form of investment deposits that earn interest, or in the form of current deposits that do not earn interest (Mahmoud, Hussein, 2007, p. 42).

7- Certificates of deposit: It is one of the sources of short-term funds in Islamic banks. These certificates are issued in different categories to suit all levels of depositors' income. The term of the certificate ranges from 1 to 3 years. The funds from these certificates are used to finance medium-term projects, and the returns are distributed monthly under the final settlement account or at the end of the term (Haider, 2011, p 42).

8- Trust units: This service is one of the important newly established banking services, which is considered an important investment area. Through this service, savings are collected from the public in the form of non-creative services that are employed in the securities markets and benefit their owners, the bank, and society. The bank also takes a limited percentage of the profit in this area, and an entity is usually designated to manage such activities.

9- Investment funds: These are investment vehicles that meet the needs and requirements of depositors to invest their funds in areas that suit them, whether domestic or foreign, to achieve attractive returns (Sadiq, 2008, pp 48-49).

Section II: Functions of Islamic banks

Banks perform various functions, which are as follows (Sadiq, 2011, pp 29-33):

1- Financing different sectors:

- Providing appropriate financing for agricultural industrial sectors.
- Providing appropriate financing for the construction and real estate sectors through manufacturing and leasing contracts.
- Providing appropriate financing for commercial activities (import and export) by applying various Islamic sales methods (such as bargaining, speculation, participation, and *murabaha* for the purchaser) and related activities such as opening documentary credits, issuing letters of guarantee, and collection and shipping bills.

In addition, Islamic banks provide advisory and technical services to their customers to help them choose the most suitable investment and financing opportunities.

2- Management of third-party investments:

Where the bank acts as a speculator through this mechanism in exchange for a percentage of the investment yield based on the speculation contract, and is entitled to that percentage only if a profit is made. In the event of a loss, the bank loses its effort and time, and the owner of the money bears the financial loss.

The bank uses this mechanism through a fixed fee or a percentage of the invested money based on a fee-based agency contract, and this fee is earned by performing the work, whether a profit is made or not.

3- Investment of funds:

Through this mechanism, the Islamic bank invests the funds available to it from its own sources with the investment accounts it receives as a (speculator) using various contracts.

Or by contributing to existing facilities, and when a profit or loss is realized as a result of these investments, the bank distributes it to the sources of the invested funds after deducting the percentage allocated to it from the profit, if realized, in its capacity as a speculator and in accordance with the agreement with the investment account holders.

4- Banking services:

The Islamic bank provides these services for a fixed fee, such as transfers, checks, opening documentary credits, issuing letters of guarantee, advisory services, ATM services through balance inquiries or transferring current accounts to savings accounts or vice versa, changing PIN numbers, issuing secure online shopping cards, and other services.

5- Social services:

The bank provides many social services through lending or from the zakat and charity fund, to develop human resources, serve the environment, and promote the concept of sustainable development by creating job opportunities for large segments of society, training them, equipping them with advanced technical skills, and providing them with financial support to lift them out of unemployment and enable them to become productive members of society.

6- Direct trading and direct investment in Islamic banks:

The bank's direct trading model is one of the ways it invests funds, in regular sales or murabaha sales.

The bank does this through various alternatives, including a department specializing in financing and credit, an independent commercial department within the bank's structure, a subsidiary commercial company, or cooperation with traders.

Islamic banks can establish new projects or participate in existing ones.

That is, they sell the goods they have previously purchased at their original price with a profit margin, which is considered a form of direct trading.

7- Guarantee of funds:

- Current account funds are guaranteed by the bank.
- Funds participating in investment accounts are subject to the actual results of operations and are therefore subject to the possibility of a decrease in expected profits.
- Islamic banks establish systems to protect deposit funds and safeguard them from the risk of loss on a cooperative and mutual basis.

Section III: Supervision of Islamic Banks

In order to protect depositors' funds, Islamic banks had to be subject to various types of supervision, the most important of which were:

1- Central Bank supervision:

The need to develop the role of the central bank in supervising Islamic banks is reflected in the establishment of a special department within the central bank, whose main responsibilities include monitoring and supervising the activities and operations of Islamic banks. This department should be staffed by professionals with extensive knowledge and experience in the work of Islamic banks.

Similarly, there should be a special register for Islamic banks with the central bank. There must also be a degree of flexibility between the central bank and Islamic banks to

facilitate procedures for opening new branches, given the economic development they can bring to society. The central bank should therefore work on developing specific forms for Islamic banks to use when submitting the data it requests on a regular basis.

These models reflect the nature of Islamic banks' operations and activities, which requires the formation of a committee comprising representatives of Islamic banks and the central bank, as well as a group of economic and banking experts. The committee's task would be to formulate the general and specialized rules and regulations that Islamic banks must follow. The aim is to use these customs and rules in the Central Bank's supervision of Islamic banks in a way that preserves the special nature of these banks (Mohammed, Kamel, 2011, p 85).

2- Sharia supervision:

The primary duty of the Sharia Board is to clarify the Sharia rulings on all contracts, transactions, and mechanisms used to execute, amend, and regulate contracts, and to work to prevent Sharia errors and violations by guiding and liaising with Sharia auditors and supervisors.

Its tasks are summarized as follows:

- Studying contract formats and regulations, the mechanisms by which contracts are implemented, and approving contract and agreement templates.
- Adopting what is agreed upon among the schools of jurisprudence, and in case of disagreement, giving preference to one school without bias, based on evidence and in a manner that achieves the interests and objectives of Sharia. In contemporary issues, deriving rulings based on the principles of the four schools of jurisprudence, after reviewing the opinions of contemporary jurists, juristic assemblies, and conferences.
- Responding to questions directed to it from the bank's management, employees, customers, and members of the general assembly.
- Verifying the commitment of employees and management to the legality of transactions through periodic reports submitted by the Sharia supervisor, and identifying errors and violations that occur or may occur through a gradual and sequential process that combines reform or confidentiality as much as possible with continuous communication with supervisors and auditors, and following up on them.
- Representing the bank at Sharia conferences and seminars (Imad, 2015, p 140).

The second axis: Risks of Islamic banking

Section I: Types of Islamic Finance Risks

Islamic banks are exposed to a range of risks, some of which are similar to those faced by conventional banks, while others are unique to Islamic banks due to their commitment to Islamic Sharia law. The risks faced by Islamic banks will be discussed as follows:

1- Credit risk:

Credit risk takes the form of settlement or payment risk arising when one party to a transaction must pay cash (e.g., in the case of a salam or istisna'a contract) or deliver assets (such as in a murabaha sale) before receiving the corresponding assets or cash, exposing it to potential loss. In the case of profit-sharing arrangements (such as mudaraba and musharaka), credit risk arises in the form of the partner's failure to repay the bank's share when due. This problem may arise as a result of information asymmetry when banks do not have sufficient information about the actual profits of businesses that have been financed on a mudaraba basis. Since murabaha contracts are trading contracts, credit risk arises in the form of counterparty risk, whereby the beneficiary of the financing defaults on its trade obligations, perhaps due to general external factors rather than specific ones.

2- Reference price risk:

It may seem that Islamic banks are not exposed to market risks arising from changes in interest rates as long as they do not deal with interest rates. However, changes in interest rates pose some risks to the revenues of Islamic financial institutions. Financial institutions use a reference rate to determine the prices of their various financial instruments. In a murabaha contract, for example, the profit margin is determined by adding a risk margin to the reference rate, which is usually the Libor index. The nature of fixed-income assets requires that the profit margin be determined once for the entire term of the contract. Therefore, if the reference price changes, it will not be possible to change the profit margin in these fixed-income contracts. For this reason, Islamic banks face risks arising from interest rate movements in the banking market.

3- Operational risks:

There may be serious operational risks in these institutions, such as employee risks. Operational risks arise when Islamic banks do not have sufficient human resources that are adequately trained to carry out Islamic financial operations, given the difference in the nature of Islamic banks' business compared to other banks. so the computer programs available on the market and used by conventional banks may not be suitable for them. This issue has created risks in the development and use of information technology in Islamic banks.

4- Legal risks:

Given the differences in the nature of Islamic financial contracts, Islamic banks face risks in terms of documenting and executing these contracts. Furthermore, since there are no standard templates for contracts for various financial instruments, Islamic banks have developed these contracts in accordance with their understanding of Sharia teachings and local laws, and in accordance with their current needs. Furthermore, the absence of standardized contracts, in addition to the lack of judicial systems that rule on cases related to the execution of contracts by the other party, increases the legal risks associated with Islamic contractual agreements.

5- Withdrawal risks:

The variable return system on savings and investment deposits leads to uncertainty about the real value of deposits. Preserving the value of assets, in the sense of reducing the risk of loss due to low rates of return, may be an important factor in customers' decisions to withdraw their deposits. From the bank's perspective, this leads to withdrawal risks, which are driven by low rates of return compared to other financial institutions.

6- Trade diversion risks:

This type of risk is the transfer of deposit risk to shareholders. It occurs when banks, due to commercial competition in the banking market, support deposit returns from shareholder profits in order to prevent or reduce depositors from withdrawing their funds as a result of low returns on them (Accounting Authority 1999). Commercial displacement risk means that, despite operating in full compliance with Sharia regulations, an Islamic bank may be unable to offer competitive returns on deposits compared to competing Islamic or conventional banks, which may again motivate depositors to withdraw their funds. To prevent this, the owners of the Islamic bank need to give up some of their share profits in favor of depositors in investment accounts (Tarek, 2003, pp 64-67).

7- Trust risks:

There is a risk that Islamic banks will breach the contracts between them and their customers. For example, an Islamic bank may not be able to fully comply with the Sharia requirements of various contracts. Since the fundamental justification for the operations of these banks is their commitment to Sharia, their inability or unwillingness to comply

could lead to a serious confidence problem and consequently to the withdrawal of deposits (Samira, 2011, p 106).

8- Liquidity risk:

Liquidity risk arises from insufficient liquidity for normal operating requirements, which reduces the bank's ability to meet its obligations on time. It is measured by the extent to which the institution can convert its assets into cash easily and readily. Given the nature of the financing formulas used in Islamic banks in their work in the real economy, they cannot be easily converted and liquidated. Therefore, a mechanism is required to liquidate financing through investment funds attached to the bank. The occurrence of these risks is due to the following controls (Adel bin Abdulrahman, 2005, p 214):

- The extent to which assets can be converted into cash.
- The existence of a liquidity management system.

Section II: Risks of Islamic Financing Formulas

Islamic banks face unique risks due to their adherence to Sharia law, known as Islamic financing risks.

1- Risks of speculation and participation:

Among the most significant risks associated with these two formulas are the following (Mouati, 2017, p 204):

- Risks resulting from the partner's failure to pay the bank's share of profits or delay in paying them;
- Risks resulting from price fluctuations, both upward and downward;
- Risks resulting from poor performance on the part of the partner or failure to study the project thoroughly;
- Reputational risks resulting from the partner's failure to comply with Sharia regulations, which affects the position of depositors in the bank;
- Risks resulting from damage to goods in the hands of the speculator;
- Risks resulting from the company's loss, or the actual profit being less than expected;
- Risks resulting from exceeding the total financing period for completing the transaction.

2- Risks of the manufacturing formula:

The *istisna'a* contract is one of the oldest contracts that was developed to meet people's needs and demands. However, it has not gained widespread acceptance in the banking sector, as its use remains limited and the financing risks in a contract of manufacture are similar to those in a contract of sale. Nevertheless, the bank often enters into a parallel contract of manufacture with another manufacturer from the outset to fulfill the customer's requirements. The bank thus acts as an intermediary between two parties without any relationship between them, whereas the bank may not enter into a parallel *salam* contract from the outset, given the different nature of each contract.

Upon receipt of the goods covered by the contract, the bank pays the full price, while it receives the amount in installments when the goods are sold on behalf of the customer. Hence, the risk is borne by two parties:

- The first manufacturer, when he is unable to pay the agreed installments or reneges on the contract, in which case the jurists consider him not bound by the contract. In this case, the bank will bear the cost of storing, marketing, and selling the goods, and may be exposed to general market risks or losses when selling them to another customer.
- From the manufacturer, if he is unable to deliver the goods at the agreed time, or to deliver them at all, in which case the bank is exposed to the risk of non-payment (Fadl, 2007, pp 59–60).

3- Risks of the lease formula:

This formula is not without risks, which can be summarized as follows:

A. Marketing risks: This involves the purchase of devices and equipment by the bank, which requires an organized marketing campaign by the bank to attract customers' attention to cooperate with the bank in this regard. Therefore, when purchasing such devices, it is necessary to take into account market needs and demand for this equipment, otherwise the bank will be exposed to significant risks in the form of capital freezing, which may cause significant losses.

B. Risks of irregular payment of rent: Failure to pay fees regularly disrupts the bank's working capital, both in terms of capital utilization and reinvestment of its liquid funds.

C. Risks of change in technological methods: Especially in the current era, which is witnessing an increasing acceleration in technological and scientific progress, and particularly what we are seeing and experiencing these days in terms of rapid technological advances in computers, with daily newspapers bringing us something new in this field every day, which requires that the leased materials be tested with extreme care and caution for fear of exposing the bank to significant risks (Abdulwahab, Hilal, 2016, p 131).

4- Risks of the Murabaha formula:

Murabaha is one of the most common forms of financing used by Islamic banks. In this form, Islamic banks may be exposed to the following risks:

- Failure of the customer to make payments as agreed, thereby depriving the bank of the opportunity to reinvest these funds;
- Deliberate postponement of payments, due to the absence of penalties for postponement, leading to higher costs for granting and monitoring financing;
- Guarantee risks, resulting from the sale of repossessed assets at below the purchase price;
- The risk of reneging on promises, as purchase promises are not binding, although most Islamic banks consider such promises to be binding;
- Delivery risks, commodity risks, and risks of goods being unsuitable or unavailable;
- The risk of the bank becoming involved in lawsuits and disputes with customers.

5- Risks of the peace formula:

Salam risk is defined as "the risk to which an Islamic bank is exposed as a result of financing the sale of goods (salam) in accordance with an agreement with the customer." This is a rarely used form of financing due to the risks involved, especially in the agricultural sector.

The main risks associated with the peace financing formula can be summarized as follows (Mokhtar, 2016, p 49):

- Failure of the customer to deliver the goods on time, in the quantity or specifications agreed upon in the contract;
- Failure to cover the return on investment;
- Risks beyond the control of the parties to the contract, such as natural disasters and climate changes that adversely affect crops and make it difficult to enforce the terms of the forward sale contract.

6- Risks of sharecropping and leasehold farming:

These are the risks faced by the bank when financing these two types of agriculture, which cause an increase in the degree of natural risk represented by the difficulty of predicting the quantities expected to be obtained from the agricultural process, especially if it relies on irregular irrigation methods, as in the case of rainfall, which fluctuates from time to time. These risks arise as a result of circumstances beyond the control of both the

bank and the farmer, so the bank avoids providing financing for agricultural activities, even though Islamic financing is based on bearing the risks arising from productive activities, which are not necessarily economic risks but may be natural risks.

The sources of these risks are:

- Unusual but recurring events: such as floods, winds, insects, and epidemics, which are events that are difficult to predict and determine their timing and extent of damage. The bank must conduct a feasibility study and determine their dimensions and extent of impact on the project's profitability in order to develop the necessary plans and strategies to deal with them when they occur.

- Unusual and infrequent events: such as pests and fires, which are predictable risks. The project manager must take precautions to mitigate their impact when they occur.

- There are other risks related to the internal organization of the project, the efficiency and experience of the worker in managing and implementing the project, and the extent to which he fulfills his commitments to the bank.

7- Risks of the good loan formula:

These are (Zaydi, 2017, pp 100-101):

- Customers' inability to pay;
- Debtors' procrastination in repaying loans;
- Financial costs and various losses resulting from legal proceedings against defaulters;
- Jurisprudential risks such as cases of procrastination and insolvency.

Third axis: Islamic banking risk management

Islamic banks are exposed to numerous risks, as mentioned above. In order to reduce or minimize the absolute level of risk, risk management has emerged to address and seek to update methods to limit these risks.

Section I: Risk Management Steps and Methods

The risk management process in Islamic banks goes through a series of integrated stages and steps to ensure that risks remain within the bank's acceptable limits. Islamic banks also follow a set of methods to minimize and limit the risks they face.

First: Risk management steps

The risk management process in Islamic banks goes through a bunch of steps to make sure it's within the bank's limits. Here are the main steps for risk management in Islamic banks (Masoudi, 2020, p 512):

1- Identifying risks: Identifying the nature and type of risks to which the bank may be exposed, whether general or specific, and accurately determining the source of the risk and the causes that led to its occurrence.

2- Risk measurement and assessment: At this stage, the risk is measured and assessed accurately in order to determine the extent of the loss that will result from the risk if it occurs. The risk is considered from three angles: its magnitude, timing, and probability of occurrence.

3- Selecting appropriate alternatives for dealing with the risk: Here, the appropriate alternative for dealing with the risk is selected, whether by avoiding the risk, distributing it, or accepting it and adapting to it. It can be said that the basic criterion for selecting the appropriate alternative is to compare the expected benefits and costs behind these risks.

4- Implementation of the resolution: The decision (appropriate alternative) is implemented with the selection of appropriate mechanisms for implementation.

5- Risk monitoring and review: Given the continuity and permanence of the risk management process in Islamic banks, the process and its results are monitored, especially in light of the rapid changes in the business environment and the accompanying

changes and renewal of the risks they face. Therefore, risks must be monitored continuously to prevent them from causing serious losses to Islamic banks.

Second: Risk management methods

Islamic banks, like other banks, follow a set of methods to mitigate the risks they may face. We will discuss the most important methods that are considered effective in the risk management process (Tahaoui, Ben Habib, p 69):

1- Keeping promises: The prevailing opinion among jurists is that binding promises are permissible, because they protect the parties involved in the financing process from loss and damage, and increase confidence in transactions. The risk management department may apply the issue of binding promises in various contracts.

2- Securities and investment funds: The aim is to take into account several important factors, most notably:

- Reduce and spread investment risk through multiple investment outlets.
- Eliminate the heavy concentration on short-term financing that dominates the business of Islamic banks.

3- Diversification and distribution of investment: To mitigate risks, Islamic banks should diversify their investment portfolios and spread their investments across multiple sectors, geographical areas, and customer segments.

4- Rental fines: That is, fining the debtor who delays payment by the amount he has failed to pay on time, which is a deterrent that prevents procrastination and does not fall under the prohibition of usury.

5- Developing risk management and transfer methods: (such as mutual insurance, securitization of share ownership rights, recourse to salam and istisna'a contracts, etc.)

6- Obtaining genuine guarantees: This is to address special cases while taking into account the provisions of Islamic law in this regard.

7- Commitment to and compliance with international supervisory standards: Basel (I-II-III): In summary, Islamic banks can use several methods such as contracts based on conditional options or binding promises, deposits, and other contracts and conditions that are permissible under Sharia law, while using permissible methods used in conventional banks such as debts, futures, options, and others to avoid methods that are prohibited under Sharia law, such as: interest rate swaps based on *riba*, debts, futures, options, and so on.

Section II: Methods and Policies for Islamic Banking Risk Management

In order to develop risk management for Islamic banks, a number of policies and methods must be employed, including the following (Shihab, 2012, pp 52-53):

- All central banks should establish specialized legislation for Islamic banks that reflects the nature of their business, activities, services, and investments.
- Central bank regulations in the area of supervision and oversight should be completely different from those governing commercial banks.
- Islamic banks should understand and develop their tools in ways that directly reflect international standards and adapt to the rapidly changing world of finance.
- Financial functions and services should be integrated and consolidated towards financial strengthening, which requires differentiating between the risks of different sectors in Islamic banks;
- Bank management needs to create a working environment for risk management by clearly defining risk management objectives and plans through systems capable of identifying, measuring, and controlling risk exposure;
- Ensuring the effectiveness of the risk management process until an internal control system is established;
- Taking into account risks that could significantly affect their operations;

- Developing an efficient risk management system and significantly improving systems;
- Allocate resources to prepare a package of periodic risk reports, such as risk capital reports, credit risk reports, operational risk reports, liquidity risk reports, and liquidity risk reports;
- Support risk information management systems, internal and external audits, and asset inventory systems and processes.

Section III: Risk Management Using Islamic Financial Engineering

Financial engineering is a source of creativity and innovation that financial institutions of all kinds, especially banks, need in order to meet the financing and investment needs of their customers.

First: The concept of Islamic financial engineering

Islamic financial engineering refers to a set of activities that include the design, development, and implementation of innovative financial instruments and processes, as well as the formulation of creative solutions to financing problems, all within the framework of Sharia law. Islamic financial engineering thus includes the following activities (Omri, Muftah, 2017, pp 149-150):

- Creating new financial tools.
- Creating new financing mechanisms.
- Creating new solutions for financial management, such as liquidity or debt management, or preparing financing formulas for specific projects that are tailored to the circumstances surrounding the project.
- Ensuring that innovations in both tools and processes are Sharia-compliant and avoid jurisprudential differences as much as possible, i.e., they are characterized by Sharia credibility.

Second: Financial engineering mechanisms as a risk management tool

Islamic financial engineering has many uses in the field of risk management in Islamic financial institutions. Researchers and professionals in the field of Islamic banking and finance are developing a number of applications, including:

1- Sale of din al-salam (or Islamic securitization) and its role in risk management:

The sale of a debt before its collection is one of the issues that raises jurisprudential disputes. Imam Malik, may God have mercy on him, permitted it if it was not food, while other imams prohibited it. Some may adopt Imam Malik's opinion and propose the idea of securitizing commodity debts on this basis. It is even possible to liquidate commodity debts in a manner agreed upon by all imams (as we have seen before, Islamic financial engineering aims to avoid jurisprudential disputes as much as possible) without any difference in the product. The creditor (the holder of the salam debt instrument) can sell a salam parallel to the first, with the same specifications and conditions, and the debt can be considered collateral for the parallel salam. If the first salam is considered collateral for the second salam, the two debts become similar in terms of risk and other characteristics (Abdul, 2008, pp 161-162).

2- Hedging using Islamic derivatives (Salam contract, Sharia-compliant option):

The salam contract is considered one of the most suitable contracts for hedging, as it enables Islamic banks to finance agricultural, industrial, and commercial activities on an individual basis and on a large-scale project basis. The Islamic bank's interest is to obtain deferred resources at a relatively cheap spot price and then, after receiving them, market them at the current or deferred price.

The legitimate option can be used to hedge against the risk of non-fulfillment of the promise by the buyer of the commodity through murabaha by agreeing with the seller

on a known option period for the commodity when purchasing it, which is known as the conditional option, whether that period is long or short.

It is also possible to hedge against exchange rate risks by standardizing the currency of employment with the currency of issuance of the instruments as much as possible, choosing stable currencies for transactions, as well as conducting mutual loans in different currencies without taking or giving interest, provided that there is no link between the two transactions, and purchasing goods or concluding murabaha transactions in the same currency. It is permissible to agree with customers on the payment of installments (Halou, Walid, p. 14).

Fourth theme: Hidden challenges facing Jordan Islamic Bank

Section I: The Reality of Financing Risks at Jordan Islamic Bank

The risks to which Jordan Islamic Bank is exposed are as follows:

1- Credit risk:

The bank's main activity is to grant financing and provide banking services to various customers. As a result, the bank is exposed to credit risk, which is defined as the inability or unwillingness of a customer to fulfill their contractual obligations to the bank. Credit risk is the main risk to which the bank is exposed, and it requires the necessary resources to manage this risk effectively (Thirty-seventh Annual Report, 2024, p 191).

Table 01: Represents exposure to credit risk after impairment provisions and expected credit losses, after deducting deferred income and contingent income, and before guarantees and other mitigants.

Unit: Jordanian dinar.

2024	2023	2022	2021	2020	2019	2018	2017	2016	2015	Years Statement
3982934885	3636419816	3573599587	3065789453	2813545236	2459330276	2272179725	2081484194	2095414097	2118011892	Total exposure to joint credit risk
1070033221	909687367	884536145	1052899716	932524542	992028125	976317359	1330526905	1316421489	1115894427	Total exposure to own credit risk

Source: Annual reports of Jordan Islamic Bank (2015-2024).

In light of the previous results in Table 1, it is clear that Jordan Islamic Bank experienced continuous fluctuations in its total exposure to credit risk, whether joint or individual, during the study period.

- Joint exposure:

An increase of 88% from 2.12 billion dinars in 2015 to 3.98 billion dinars in 2024.

The biggest jump was between 2021 and 2022, with an increase of 508 million dinars, which may indicate:

- A significant expansion in lending (especially to large companies or sectors)
- Increased exposure to high-risk sectors (such as real estate or joint ventures)
- A change in credit policies or terms.

- Self-exposure:

The highest value was in 2017, estimated at 1.33 billion dinars, and the lowest value was 884 million dinars in 2022, with a sharp decline of 976 million dinars in 2018, followed by a partial recovery until 2024, which may indicate:

- A reduction in individual loans or a shift by the bank towards joint financing.
- Settlement of non-performing loans or sale of an internal credit portfolio.

2- Liquidity risk: Liquidity risk is the risk that a bank will be unable to provide the necessary funding to meet its obligations when they fall due.

3- Market risks: Market risks arise from fluctuations resulting from market price movements specific to equity instruments in the trading register, currency exchange rates, market yield rates, commodity prices, and inventory. We find:

A. Return rate risk: The risk of return rate is defined as a decrease in the rate of return on investments compared to the local market, which arises due to a bank's inability to increase the rate of return on loans granted at a fixed rate (such as murabaha).

B. Foreign currency risks: Risks arising from changes in the exchange rates of foreign currencies held by the bank.

C. Stock price risk: Price risk arises from changes in the fair value of equity investments.

D. Commodity risks: Commodity risks arise from fluctuations in the value of tradable or leaseable assets and are related to current and future fluctuations in the market values of specific assets, where exposure is to the price volatility of commodities purchased and paid for in full after the conclusion of forward contracts through the holding period and to the volatility in the residual value of leased assets as at the end of the lease term (Thirty-seventh Annual Report, 2019, p 164).

4- Compliance risks: Be aware of the risks of legal or regulatory penalties, financial losses, or reputational risks that the bank may face as a result of non-compliance with laws, regulations, instructions, orders, rules of conduct, standards, and sound banking practices. The most significant risks of non-compliance with laws and regulations include financial losses, financial crimes, money laundering, fraud, and corruption.

5- Operational risks: These risks are losses resulting from inadequate or failed internal procedures or systems, or from external events, including, for example, legal risks and risks of non-compliance with Sharia law.

6- Reputation risk: These risks arise as a result of a negative perception of the bank, which may lead to losses in funding sources or cause customers to switch to competing banks.

7- Information technology risks: The increasing use of information technology has improved the effectiveness and efficiency of the Bank's operations and services, but has also brought with it new risks related to information technology.

Section II: Mechanisms for limiting financing risks at Jordan Islamic Bank

Jordan Islamic Bank manages the risks it is exposed to in accordance with the general risk management framework set by the Board of Directors.

1- Credit risk management: Credit Risk Management System (Thirty-seventh Annual Report, 2024, p 191):

The bank's main activity is granting financing and providing banking services to various customers. As a result, the bank is exposed to credit risks. Credit risk management is based on several steps, the most important of which are:

- Determining credit concentrations and ceilings:

The bank's credit policy includes specific and clear percentages for the maximum credit that can be granted to any customer, and there are also ceilings for the amount of credit that can be granted at each management level.

- Identify risk mitigation methods: This can be achieved through the following:

- Diversification and distribution of credit investments across different sectors and geographical areas.

- Clear credit limits and continuity in accordance with Central Bank instructions for each type of investment.

- Collateral based on its marketability and coverage ratio for the credit granted.

- Credit approval powers vary from one administrative level to another. They depend on the size of the financing and the degree of risk.

- Limiting the risks of concentration in assets and liabilities:

The bank works effectively to manage this aspect of risk, as its annual plan requires the targeted distribution of credit across several sectors with a focus on promising sectors. In addition, the plan includes the distribution of credit across geographical areas within the Hashemite Kingdom of Jordan.

- Credit assessment, monitoring, and follow-up:

Credit applications are prepared by the business departments, and the credit department exercises due diligence in reviewing credit applications. and then forwards applications of relatively high importance to the risk management department to identify the risks associated with the customer and the credit policy and highlight the most important observations. - if any - and then the credit application is presented to the competent credit committee, in order to achieve the principle of separation of duties (Thirty-seventh Annual Report, 2024, p 192).

- Large, small, and medium-sized companies and high net worth individuals are assessed through the internal credit rating system (Moody's), at the Risk Obligor (ORR) Rating level and at the Facility Rating Risk (FRR) level.

- The credit rating at the facility level (FRR) represents the quality of credit risk mitigants provided by the counterparty, which measures the ratio of losses in the event of default (Loss Given Default).

- Financing applications for retail banking customers granted consumer financing are assessed in accordance with the individual/consumer credit rating system.

- The authority to grant financing is determined (automatic system, branch committee, management committees) in accordance with the matrix of powers approved by the Board of Directors and senior management on the basis of the amount, fulfillment of the conditions for the grant, and the degree of risk of the funding request.

2- Liquidity risk management:

Liquidity risk management consists of the following:

- Liquidity analysis.

- Maintaining a reasonable liquidity ratio to meet outgoing cash flows.

- Diversifying sources of financing.

- Having an assets and liabilities committee.

- Distributing financing across different sectors and geographical areas to reduce the concentration of risk.

- Liquidity is measured and managed based on normal and emergency conditions, including the use and analysis of maturities of assets and liabilities and various financial ratios (Thirty-seventh Annual Report, 2016, p 164).

3- Market risk management:

Market risk management consists of the following:

- Diversify investments and spread them across several sectors and geographical areas.

- Study investment return guidelines, future exchange rates, and investment in light of studies.

- Set investment limits at the country, currency, market, instrument, and counterparty levels.

- Harmonize operations centers as much as possible and in accordance with Islamic banking guidelines (40th Annual Report, 2018, p 181).

A. Yield rate risk management: The bank manages yield rate risk through the following:

- Managing yield and cost rate gaps for assets and liabilities according to time periods.

- Studying investment return trends (Thirty-ninth Report, 2017, p 176).

B. Foreign currency risk management:

Currencies are managed on a spot basis, and foreign currency positions are monitored daily against the limits approved for each transaction. The Bank's general policy for foreign currency management is based on liquidating positions on a first-come, first-served basis and covering the required position according to customer needs.

The bank's investment policy stipulates that the maximum foreign currency positions must not exceed 15% of total shareholders' equity or 50% of the bank's total foreign currency liabilities, whichever is greater (with a maximum of 5% of total shareholders' equity for each transaction, except for the US dollar) in order to cover customer needs for documentary credits, remittances, and collection services, and not for the purpose of speculation or trading (41st Annual Report, 2019, p 196).

C. Stock price risk management:

The bank manages these risks by diversifying its investments across several geographical regions and economic sectors. Most of the bank's equity investments are listed on the Amman Stock Exchange.

4- Compliance risk management:

To protect the bank from these risks, the Compliance Control Department ensures that the bank and its internal policies comply with the laws, regulations, instructions, orders, rules of conduct, standards, and sound banking practices issued by local and international regulatory authorities. This is achieved by establishing and developing a compliance policy and compliance manual, as well as preparing and developing a general policy to combat money laundering, preparing procedures and work manuals regarding internal and external laws, regulations, and instructions, preparing a code of ethics, and holding periodic training sessions (Thirty-sixth Annual Report, 2014, p 174).

5- Operational risk management: The bank manages these risks through the following:

- Reviewing the bank's operations and preparing documented work procedures that include all the necessary controls to reduce the likelihood of operational events.

- Preparing a business continuity plan (BCP) to minimize disruptions faced by the bank and a recovery plan to mitigate the effects and losses resulting from commitments.

- Ensuring the integrity of the bank's contracts and documents.

- The legal department ensures the integrity of the bank's contracts and documents.

- The IT department coordinates and cooperates with the information security department, the internal control department, and the internal audit department to develop the necessary policies and procedures to maintain the confidentiality of information in the bank and the powers of access to information programs and systems (The 39th Annual Report, 2017, p 180).

6- Reputation risk management:

The bank manages these risks by taking a series of measures that serve to strengthen customer confidence in the bank, provide high-quality banking services, maintain banking secrecy, refrain from engaging in illegal activities or financing undesirable sectors, and provide adequate protection systems.

7- Information Technology Risk Management:

It is managed under the supervision of the Information Technology Steering Committee and the Risk Management Committee, which are affiliated with the Board of Directors, to avoid exposure to risks or mitigate their impact. This is achieved through continuous monitoring and assessment of IT-related risks and their impact on banking operations in terms of the added value of technical solutions compared to their cost, and in terms of the quality and nature of technology-based projects resulting from their implementation (41st Annual Report, 2019, p 200).

Conclusion:

Risk management in Islamic banks is a constantly evolving topic. and because Islamic banks operate differently, this different nature has created new risks, requiring new and effective methods to manage them. Islamic banks must therefore develop risk management tools and mechanisms and ensure the guarantees they require, as they are exposed to risks despite the guarantees granted to mitigate and reduce these risks.

The study reached the following conclusions:

- Islamic banks face many risks similar to those faced by conventional banks, including operational risks, as well as risks unique to Islamic financing.
- Risk management is a necessary and essential tool for the continued success of the bank.
- The Risk Committee at Jordan Islamic Bank reviews risk management policies and makes recommendations to the Board of Directors.
- Assisting the Board of Directors in managing the risks to which the bank is exposed, such as credit risk, market risk, liquidity risk, and operational risk.
- Ensuring that appropriate risk management systems are in place, such as an operational risk management system and a credit rating system for customers, etc.
- Monitor risk exposure limits at the country, currency, maturity, counterparty, market, and sector levels.
- Study acceptable risk limits and recommend them to the Board of Directors for approval.
- Track, measure, control, and monitor the risks to which the bank is exposed.

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