MODERN APPROACHES TO CREDIT RISK MANAGEMENT IN ISLAMIC BANKING

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Annotatsiya: *Ushbu maqola Islomiy banklarda kredit riskini boshqarishni tahlil qiladi, uning Shariatga asoslangan tamoyillari va an'anaviy tizimlardan farqli mexanizmlarini ta'kidlaydi. Foizga asoslangan moliyalashtirishdan farqli o'laroq, Islomiy banklar murabaha, ijara, mudoraba va musharaka kabi aktivga asoslangan va sheriklik shartnomalari orqali faoliyat yuritadilar, bu esa kredit riskining mohiyatini o'zgartiradi. Maqola AAOIFI va IFSB tomonidan ishlab chiqilgan, Basel standartlarini to'ldiruvchi, muvofiqlik va barqarorlikni ta'minlovchi ramkalarni yoritadi. Ayniqsa Malayziya tajribasi shuni ko'rsatadiki, Islomiy banklar risklarni bo'lishish modellari, yuqori kapital yetarliligi va axloqiy majburiyat tufayli yuqori chidamlilikni namoyon etadi. Shunday qilib, samarali kredit riskini boshqarish nafaqat moliyaviy, balki axloqiy maqsadlarga xizmat qiladi, barqarorlik, shaffoflik va global Islomiy moliya tizimida barqaror rivojlanishni rag'batlantiradi.*

Аннотация: *Данное исследование анализирует управление кредитным риском в исламском банкинге, акцентируя внимание на его шариатских основах и отличительных механизмах по сравнению с традиционными банковскими системами. В отличие от финансирования на основе процентов, исламские банки действуют через договоры, обеспеченные активами, и партнерские контракты, такие как мурабаха, иджара, мудараба и мушарака, что изменяет характер кредитного риска. В статье освещаются рамки, разработанные AAOIFI и IFSB, дополняющие стандарты Базеля для обеспечения соответствия требованиям и стабильности. Эмпирические*

данные, особенно по Малайзии, показывают, что исламские банки демонстрируют большую устойчивость благодаря моделям распределения рисков, высокой достаточности капитала и моральной ответственности. Эффективное управление кредитным риском таким образом служит как финансовым, так и этическим целям, способствуя стабильности, прозрачности и устойчивому развитию глобальной исламской финансовой системы.

Abstract: *This study analyzes credit risk management in Islamic banking, emphasizing its Shariah-based foundations and distinct mechanisms compared to conventional systems. Unlike interest-based finance, Islamic banks operate through asset-backed and partnership contracts such as murabaha, ijara, mudaraba, and musharaka, which reshape the nature of credit risk. The paper highlights frameworks developed by AAOIFI and IFSB, complementing Basel standards, to ensure compliance and stability. Empirical evidence, particularly from Malaysia, shows that Islamic banks display greater resilience due to risk-sharing models, higher capital adequacy, and moral commitment. Effective credit risk management thus serves both financial and ethical objectives, promoting stability, transparency, and sustainable development within the global Islamic financial system.*

Key words: *Islamic banking, credit risk management, Shariah compliance, risk-sharing, AAOIFI, IFSB, Basel Accords, financial stability, moral responsibility, sustainable development.*

Introduction.

Credit risk is one of the most fundamental and widespread types of risk in banking activities, representing the probability that a borrower will fail to fulfill their obligations under the agreed terms[1]. This risk directly affects the stability of the banking system and, despite the introduction of various financial innovations and risk mitigation tools in recent years, continues to be one of the primary causes of bank failures[2]. Credit risk management has existed since ancient times. In early

[1] Principles for the Management of Credit Risk - Oct 2000. https://www.bis.org/publ/bcbs75.pdf
[2] Van Greuning & Brajović Bratanović, 2006. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/615671468152704936

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civilizations, various mechanisms were employed to mitigate this risk. For example, in Assyria and Babylon, collateral was an integral part of credit agreements, while in ancient Greece, in addition to mortgage-backed loans, guarantees by reputable individuals were also used as a means of ensuring repayment. Similar approaches were observed during the Islamic period, as the Prophet Muhammad (peace be upon him) used al-rahn (collateral) as a guarantee for debt repayment[3].

The methods of managing credit risk and the instruments for risk protection developed rapidly in subsequent centuries. In the early eighteenth century, Japan witnessed the emergence of the first forms of commodity derivatives (futures contracts), and by the mid-nineteenth century, such instruments had become widely used on organized exchange markets in the United States. By the 1970s, financial derivatives had become among the most effective tools for mitigating credit risk[4]. However, these instruments primarily served to manage risk at the level of individual financial institutions. To regulate credit risk on an international scale and to establish common standards, the Basel Accords (BCBS, 1988, 2004, 2010) were adopted. These documents played a critical role in promoting unified approaches to credit risk management, defining minimum capital requirements, and strengthening supervisory mechanisms, thereby enhancing the stability of the global financial system.

At the same time, Islamic banks possess distinctive characteristics in credit risk management, as their operations are governed by Shariah principles, which prohibit interest (*riba*). Unlike conventional banking, Islamic banks rely on asset-based, trade, and partnership-oriented financial instruments rather than interest-bearing loans[5]. This alters the nature of credit risk:

- in *murabaha* contracts, for instance, the buyer may default on payments;

- in *ijara*, the lessee may fail to meet rental obligations or terminate the lease prematurely;

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[3] https://qurangallery.app/topics/taking-collateral-rahn-islamic-finance-quran#:~:text=At%20a%20Glance,central%20themes%20in%20the%20Quran.

[4] Risk Management: History, Definition, and Critique. https://onlinelibrary.wiley.com/doi/10.1111/rmir.12016

[5] Financial Risk Management for Islamic Banking and Finance https://www.researchgate.net/publication/265755955_Financial_Risk_Management_for_Islamic_Banking_and_Finance

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- in *salam* and *istisna* contracts, delays in the delivery of goods or services may occur;

- in *mudaraba* and *musharaka* partnerships, the primary source of credit risk lies in the potential underperformance of the financed project.

Consequently, identifying and assessing credit risk in Islamic banking is more complex than in conventional systems, as it is closely linked to the Shariah-compliant nature of each financial instrument [6]. However, because the Basel standards did not fully account for the specific features of Islamic banking, international Islamic financial institutions developed their own regulatory frameworks to address these gaps. Notably, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) introduced standards tailored to Islamic banks regarding capital adequacy and risk management (AAOIFI, 1999; IFSB, 2005a; IFSB, 2005b). These frameworks contributed to the establishment of effective methods for managing credit risk, strengthening capital bases, and developing risk-based supervisory systems. As a result, the processes of identifying, assessing, and mitigating credit risk in Islamic banking have gradually become standardized on an international scale.

The level of exposure to credit risk in Islamic banks depends on multiple factors, including bank size and capital adequacy, the degree of clients' adherence to religious values, the decentralization of management structures, and the availability of Shariah-compliant hedging instruments. Moreover, macroeconomic conditions particularly during periods of global financial crises have significantly influenced the credit risk profiles of Islamic banks. From this perspective, effective credit risk management in Islamic banking is essential not only for ensuring financial stability but also for supporting social justice and economic development in accordance with the principles of Shariah.

Main Body.

[6] Islamic Banking and Finance: Recent Empirical Literature and Directions for Future Research. https://www.researchgate.net/publication/278625184_Islamic_Banking_and_Finance_Recent_Empirical_Literature_and_Directions_for_Future_Research

The theory of credit risk management in Islamic banking differs fundamentally from that of the conventional financial system, as it is based on Shariah principles. The Islamic financial framework strictly prohibits *riba* (interest), *gharar* (excessive uncertainty), and *maysir* (gambling). As a result, Islamic banks manage credit risk primarily through asset-backed transactions and by sharing risks with their clients under partnership-based contracts. Credit risk is generally defined as the likelihood that one of the contracting parties will fail to meet its financial obligations (BCBS, 2000). However, in Islamic banking, this concept is interpreted differently depending on the specific characteristics of each financial instrument[7].

The main objective of credit risk management in Islamic banks is to ensure the adequacy of capital, liquidity, and institutional stability[8]. In parallel with the Basel Accords (1988, 2004, 2010), which set international capital adequacy standards, Islamic finance has developed its own regulatory framework through the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 1999) and the Islamic Financial Services Board (IFSB, 2005a; 2005b). These institutions have established principles for identifying, assessing, monitoring, and mitigating risks specific to Islamic financial instruments. According to the IFSB's *Guiding Principles of Risk Management*, Islamic banks must manage risks in a manner that maintains financial stability, balances risk and return, and ensures compliance with Shariah.

Table №1

Credit Risk Management in Islamic vs. Conventional Banking

Aspect	**Conventional banking**	**Islamic banking**
Foundation	Interest-based system	Shariah-based, prohibits riba, gharar, maysir

[7] Financial Risk Management for Islamic Banking and Finance https://www.researchgate.net/publication/265755955_Financial_Risk_Management_for_Islamic_Banking_and_Finance
[8] Islamic Banking and Finance: Recent Empirical Literature and Directions for Future Research https://www.researchgate.net/publication/278625184_Islamic_Banking_and_Finance_Recent_Empirical_Literature_and_Directions_for_Future_Research

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Nature of Contracts	Debt-based	Asset-backed or partnership-based
Risk Treatment	Risk transfer via interest and derivatives	Risk sharing through PLS (mudaraba, musharaka)
Sources of Credit Risk	Borrower default	Default, project losses, delivery delays
Risk Mitigation Tools	Collateral, insurance, derivatives	al-Rahn, Kafala, Takaful
Supervisory Mechanisms	Central bank and financial authority	Shariah Supervisory Board + regulatory bodies (AAOIFI, IFSB)

The nature and sources of credit risk in Islamic banking are shaped by the structural and operational specificities of Islamic finance. Studies based on the Malaysian experience identify the main factors affecting credit risk as the structure of financing, asset quality, managerial efficiency, and the level of Shariah compliance. Islamic banks' direct linkage to the real economy through asset-backed financing means that risk is connected to actual economic activities rather than speculative transactions[9]. Consequently, the emergence of credit risk is not limited to borrower default but may also result from project underperformance, production delays, or failure in goods delivery.

Risk management in Islamic banking functions at both contractual (micro) and institutional (macro) levels[10]. At the contractual level, the focus is on the design of financial agreements, risk-sharing mechanisms, and collateralization. Instruments such as *al-rahn* (collateral), *kafala* (guarantee), and *takaful* (Islamic insurance) are widely utilized to mitigate credit risk. At the institutional level, Islamic banks

[9] Economic Development and Islamic Finance. Zamir Iqbal and Abbas Mirakhor. https://documents1.worldbank.org/curated/en/798771468050094748/pdf/798910PUB0Econ00Box377374B00PUBLIC0.pdf
[10] Financial Risk Management for Islamic Banking and Finance. *https://www.researchgate.net/publication/265755955_Financial_Risk_Management_for_Islamic_Banking_and_Finance*

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employ portfolio diversification, continuous risk monitoring, and capital adequacy maintenance. However, unlike conventional finance, the transfer of credit risk through derivatives or similar instruments is prohibited by Shariah, leading Islamic banks to adopt risk-sharing rather than risk-transfer models[11].

Empirical research indicates that Islamic banks particularly small and medium-sized ones tend to exhibit stronger resilience to credit risk than conventional banks. This resilience is attributed to higher capital adequacy levels and the moral commitment of clients to fulfill obligations in line with religious values. Moreover, as Islamic financial instruments are based on profit-and-loss sharing, part of the risk is distributed among investors, reducing the bank's overall credit exposure[12].

The effectiveness of risk management in Islamic banking also depends on governance quality, the transparency of oversight systems, and the role of the Shariah Supervisory Board[13]. The Shariah Board reviews and certifies the compliance of financial operations with Islamic law, indirectly contributing to credit risk reduction. Another factor influencing credit risk is information asymmetry between lenders and borrowers[14]. However, in Islamic finance, this problem is partly mitigated through partnership-based contracts, where both parties share risks and returns, thereby encouraging greater information exchange.

Table №2

Factors influencing credit risk in Islamic Banks

Category	**Key Factors**	**Impact on Credit Risk**
Internal Factors	Asset quality, financing structure, managerial efficiency	Directly influence default probability
Governance	Shariah compliance, transparency, board oversight	Enhances risk control and moral behavior

[11] The Economics of Islamic Finance and Securitization https://www.researchgate.net/publication/5125128_The_Economics_of_Islamic_Finance_and_Securitization
[12] Determinants of Islamic bank profitability in the MENA region. Ben Khediri & Ben-Khedhiri, 2009. https://www.researchgate.net/publication/46514899_Determinants_of_Islamic_bank_profitability_in_the_MENA_region
[13] Hennie Van Greuning and Zamir Iqbal Risk Analysis for Islamic Banks The World Bank, Washington, D.C. 2008
[14] Credit Rationing in Markets With Imperfect Information. https://www.researchgate.net/publication/4733120_Credit_Rationing_in_Markets_With_Imperfect_Information

Behavioral	Borrower religiosity, information sharing	Reduces moral hazard and default risk
Macroeconomic	GDP growth, inflation, liquidity, political stability	Affect overall portfolio performance

Macroeconomic variables also play a vital role in determining credit risk levels in Islamic banks. Economic growth, inflation, liquidity in an interest-free environment, and political stability significantly affect credit portfolio performance[15]. Empirical analyses conducted during the global financial crisis demonstrated that Islamic banks were generally more stable than their conventional counterparts, largely due to their real-economy orientation and avoidance of speculative activities[16].

The diagram below illustrates the classification of financial risks within the framework of credit risk modelling, distinguishing between systematic and unsystematic risks. Systematic risks are external and uncontrollable by individual organizations, being macroeconomic in nature. They include interest rate risk, market risk, and inflationary or purchasing power risk each influenced by broad economic forces such as interest rate fluctuations, market volatility, or inflation trends. Conversely, unsystematic risks are micro-level and controllable, arising from internal management and operational conditions. These encompass business or liquidity risk, financial or credit risk, and operational risk. Financial risk involves elements such as exposure rate, recovery rate, and sovereign or settlement risk, while operational risk covers model, legal, and political risks. Overall, the diagram demonstrates how effective credit risk modelling requires identifying and managing both external macroeconomic factors and internal organizational vulnerabilities to maintain financial stability.

[15] Bank Specific and Macroeconomics Dynamic Determinants of Credit Risk in Islamic Banks and Conventional Banks. https://www.researchgate.net/publication/277325021_Bank_Specific_and_Macroeconomics_Dynamic_Determinants_of_Credit_Risk_in_Islamic_Banks_and_Conventional_Banks

[16] The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study. https://www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf

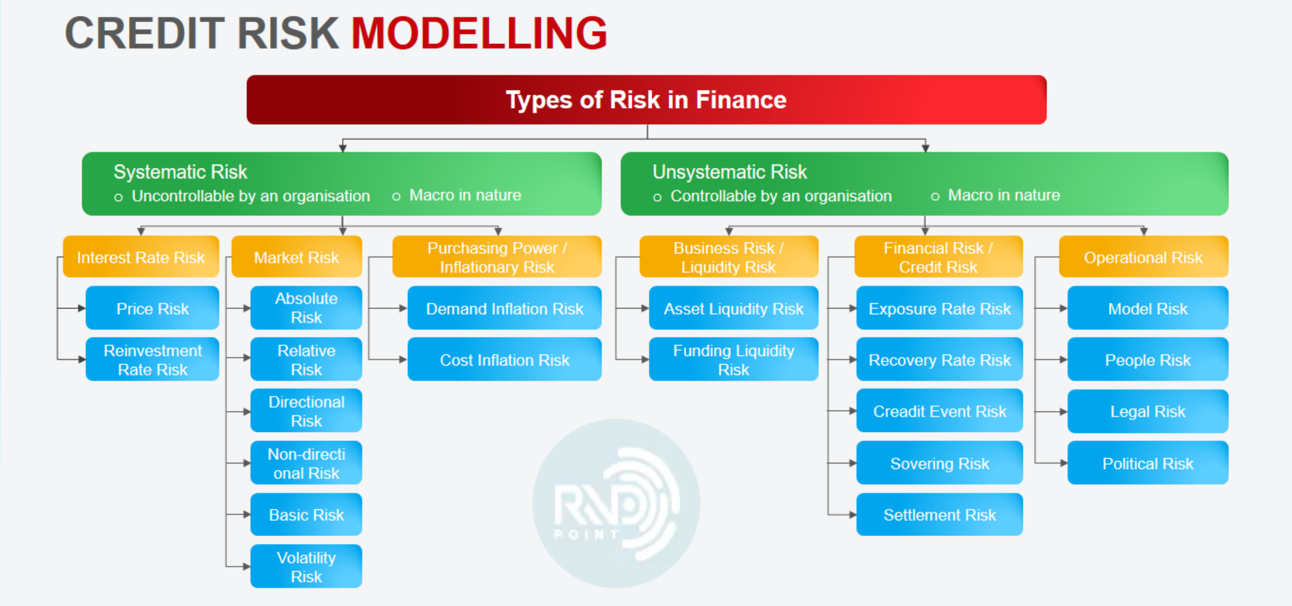

Figure 2. Conceptual model of credit risk management process in Islamic Banking[17].

Overall, the Islamic model of credit risk management aims to achieve both financial stability and social justice by ensuring equitable risk distribution and efficient resource allocation in accordance with Shariah principles. This approach integrates ethical and moral dimensions into financial practices, viewing credit risk management not merely as a means to prevent losses but as a mechanism for promoting a fair, transparent, and sustainable financial system[18].

Conclusion.

Credit risk management in Islamic banking represents a multidimensional and strategically significant component of the financial system, shaped by both Shariah principles and conventional risk management standards. Unlike conventional banks, Islamic financial institutions operate on asset-backed, trade-based, and partnership-oriented contracts, which fundamentally alter the nature and sources of credit risk. This necessitates specialized approaches to risk identification, assessment, monitoring, and mitigation, integrating both contractual (micro-level) and institutional (macro-level) mechanisms.

[17] https://www.google.com/url?sa=i&url=https%3A%2F%2Fpowerslides.com%2Fpowerpoint-business%2Fbusiness-models%2Fcredit-risk-modelling%2F&psig=AOvVaw3MQ-tegvRbUazBv3eBJq2K&ust=1762869326343000&source=images&cd=vfe&opi=89978449&ved=0CBUQjRxqFwoTCPDhm5Le55ADFQAAAAAdAAAAABBL

[18] CREDIT RISK DIFFERENTIAL BETWEEN ISLAMIC AND CONVENTIONAL BANKS IN MALAYSIA. https://e-space.mmu.ac.uk/629753/8/JSEAE%20accepted%20version.pdf

Empirical evidence demonstrates that Islamic banks exhibit notable resilience during periods of economic stress, attributable to their real-sector orientation, risk-sharing structures, moral commitment of clients, and higher capital adequacy levels. Governance quality, Shariah compliance, and transparency in oversight play critical roles in reinforcing credit risk management, while macroeconomic conditions continue to exert a significant influence on portfolio performance. The institutional frameworks developed by AAOIFI and IFSB provide standardized methodologies tailored to the unique characteristics of Islamic financial instruments, bridging gaps left by conventional Basel standards and promoting financial stability at both national and international levels.

Overall, effective credit risk management in Islamic banking is not solely an economic imperative but also a moral and institutional responsibility, ensuring equitable risk distribution, ethical financial practices, and sustainable development. Future research and practical innovation should focus on the integration of digital technologies for risk monitoring, the development of Shariah-compliant hedging instruments, and the strengthening of linkages between corporate governance and Shariah supervision. Such initiatives will enhance the capacity of Islamic banks to manage credit risk efficiently, maintain financial stability, and uphold the principles of social justice and economic development enshrined in Shariah.

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