Journal of Economics and Social Sciences (JESS)
Vol. 5, 2 (July-December, 2026), pp. 239-248
EISSN: 2830-5264, DOI: https://doi.org/10.59525/jess.2201

Operational Dynamics and Treasury Governance of Islamic Banking: Functional Analysis, Risk Management, and Systemic Comparison

Agung Lesmana[1], Surono[1], Muhammad Hasyimi Al Rasid[1]

[1] Universitas PTIQ Jakarta, Indonesia

ARTICLE INFO

Keywords:

Treasury Governance;
Independent Risk Management;
Three-Line Defense Model;
PSRG Framework;
Sharia Money Market

Article history:

Received 2026-09-09
Revised 2026-10-13
Accepted 2026-11-18

ABSTRACT

The treasury practice of Islamic banking is still trapped in synthetic replication of conventional instruments and jurisdictional confusion, where the treasury unit often doubles as an independent risk validation function, thus triggering conflicts of institutional interest. This study aims to reconstruct the functional demarcation of treasury governance and to formulate a money market framework aligned with substantive sharia principles. Using a qualitative approach through library *research* based on agency theory, the *three-line defense model*, and *maqāṣid al-sharī'ah*, the primary and secondary data corpus is analyzed through qualitative content analysis and systemic comparison. The research results prove that the treasury unit holds the position of first-line risk owner who must be independently separated from second-line risk supervision. The formulation of the original *Purpose-Structure-Risk-Governance* (PSRG) framework successfully transformed the normative prohibitions of usury, gharar, and maisir into programmatic operational decision parameters at the transaction table through the requirement of *real underlying assets*. Monetary and banking authorities are recommended to adopt the PSRG framework into money market product codification guidelines, restructure risk-adjusted return-based dealer performance indicators (*RAROC*), and accelerate digital automation of transaction document verification.

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Corresponding Author:
Agung Lesmana
PTIQ University Jakarta, Indonesia; agunglesmana@gmail.com

1. INTRODUCTION

Treasury activities play a strategic role in supporting liquidity intermediation and maintaining balance sheet stability in the contemporary Islamic banking industry. The management of assets and liabilities in Islamic banking faces challenges such as global economic uncertainty, risks of maturity mismatches between assets and liabilities, and limitations in money market instruments that comply with Sharia principles. This condition becomes increasingly complex as Islamic banks must meet international prudential standards, especially the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), while the availability of instruments that meet the High-Quality Liquid Assets

(HQLA) qualification remains a structural challenge (Yulfiswandi & Halim, 2024). Empirical research shows that the limitations of sharia liquidity instruments can affect the bank's ability to meet liquidity requirements while maintaining profitability (Ayub et al., 2023). In addition, differences in funding structures and fund placement characteristics also affect the ability of Islamic banks to adjust to short-term and long-term liquidity needs (Abdo et al., 2023). These risks are also related to macroeconomic conditions and the effectiveness of banking regulations, whose impact on the liquidity of Islamic banks can vary between countries (Anis & Hamdi, 2022). This condition highlights fundamental issues regarding the ability of treasury activities to balance optimizing portfolio profitability with maintaining liquidity resilience and financial stability in Islamic banking.

Islamic banking practices in the field still show a significant gap between claims of sharia differentiation and the reality of operational execution of money market transactions. Most treasury operations at the practical level often reduce sharia distinction to merely changing the terminology of interest to reward or margin without substantially modifying the transaction architecture. Hedging transactions and liquidity placements often adopt synthesis mechanisms that approach the yield profile of conventional instruments, thus triggering public doubt and risks of sharia non-compliance (Abdul-Rahim et al., 2023). Contemporary scientific debates highlight the failure of financial institutions to transform the normative prohibitions of riba, gharar, and maisir into binding operational decision parameters (Abdulrahman et al., 2024). This implementation gap proves that the operationalization of sharia principles requires verification parameters of economic substance that go far beyond the formalities of contract legalism.

A crucial research problem is rooted in the confusion of functional boundaries between treasury business management and independent risk management supervision. The attribution of treasury as the operational risk center is often misunderstood as the executor of the risk management function itself, thus obscuring the principle of separation of duties. Combining risk-taking roles with the authority to validate exposure limits has the potential to create conflicts of interest that endanger institutional governance (Asutay & Yilmaz, 2025). Modern banking regulations and a three-line defense model explicitly place treasury in the first line of business, while risk management operates independently on the second line to provide objective assessment (Ebrahim & Abdelfattah, 2021). Failure to separate these two jurisdictions risks crippled internal oversight mechanisms and increases exposure to liquidity risks as well as reputational risks.

Previous studies on Islamic banking have shown progress, but their discussions are still scattered with a focus that is not yet fully integrated. (Mikou et al., 2024) mapping liquidity risk research, especially in identification, measurement, mitigation, governance, interbank relations, regulation, and sharia compliance. Meanwhile, (Wasim & Zafar, 2024), through a systematic review of 93 articles, grouped the study of sharia governance into measurement, disclosure, performance, and risk management. On the balance sheet side, Abdo et al. compared the liquidity ownership adjustments of Islamic banks and conventional banks (Abdo et al., 2023), while (Chattha et al., 2020), testing the asset-liability duration gap between the two bank groups. The map shows the lack of strong integration of treasury operational level analysis linking balance sheet decisions, money market instruments, market risk, and contract compliance verification within a single comparative framework. This analysis is necessary to assess the interconnectedness of these decisions as well as their impact on the resilience and performance of banks in a dual banking system.

This research offers a conceptual approach through the Purpose-Structure-Risk-Governance framework that integrates operational dynamics, risk mitigation, and sharia governance simultaneously. This comprehensive approach transforms normative fiqh muamalah arguments into operational decision-making rules compatible with current regulatory standards. The application of this framework allows Islamic banking to simultaneously test the validity of treasury transactions from the aspects of economic objectives, contract validity, risk limit compliance, and supervisory accountability. This multidimensional synthesis provides original theoretical contributions in correcting governance confusion between business units and risk control functions. The urgency of this

study lies in providing strategic guidance for regulators and practitioners in strengthening the stability of the Islamic financial system amid the transformation of global money market regulations.

2. METHODS

This research uses a qualitative approach with *a* descriptive-analytical and systemic comparative literature study type. This approach was chosen to dissect conceptual complexities and operational misalignments in the treasury governance of Islamic banking that cannot be reached solely through quantitative measurement. The study is aimed at exploring the functional integration between the treasury business unit and the independent risk management unit, while also testing the alignment of the money market transaction architecture with sharia principles. The exploratory-critical nature of this research allows for an in-depth reconstruction of the jurisdictional boundaries of institutional governance in Islamic banking based on the principles of fiqh muamalah and modern prudential regulations. This theoretical investigation focuses on the function of treasury as the organizational capability of Islamic banking in facing the dynamics of global market risk and liquidity.

The data sources in this study are divided into primary and secondary data collected through targeted literature documentation techniques (purposive documentary search). The primary data corpus includes regulations from Indonesian banking authorities such as POJK Number 2 of 2024, POJK Number 20 of 2025, as well as Bank Indonesia's PADG Number 20 of 2024 jo. Number 12 of 2026. Primary data is also supported by the international prudential standards of the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions. Secondary data is sourced from reputable international scientific literature, authoritative reference books, and Scopus-indexed journal articles from 2021–2026 that examine risk management and sharia governance. Literature screening was conducted selectively by establishing criteria for inclusion of substantive relevance to treasury transactions.

The data analysis technique applied *qualitative content analysis combined* with systemic comparative analysis and theoretical-juridical data triangulation. The analysis procedure proceeded through four systematic methodological stages. The first stage identified the spectrum of activity and exposure of inherent risks on the treasury transaction table. The second stage separated the functional boundaries between the first-line risk-taking business unit and the second-line independent risk supervision unit. The third stage compared conventional and sharia contract architectures based on economic objectives and underlying assets. The fourth stage transformed the normative prohibitions of riba, gharar, and maisir into operational decision parameters through the Purpose-Structure-Risk-Governance framework. The validity of the findings was tested through triangulation of regulatory sources, empirical literature, and muamalah principles.

3. FINDINGS AND DISCUSSION

Functional Dynamics and Jurisdictional Boundary Governance: Reconstructing the Separation of Roles between Treasury Business and Independent Risk Management

Documentary investigations into Islamic banking practices found conceptual confusion that equates the treasury label as a risk center with the function of implementing institutional risk management. Treasury transaction desks are often treated as if they have self-legitimacy to validate their own exposure limits. This confusion in understanding creates functional dissonance that endangers bank stability, considering that treasury transaction desks essentially operate as risk-taking business units to pursue portfolio yield targets. Dealer personnel working under the pressure of revenue targets have a natural drive to maximize market position and liquidity limit tolerances. Self-supervision by business units inherently creates conflicts of interest that undermine the objectivity of the bank's internal controls. These findings align with modern prudential governance principles that affirm that profit-generating entities are prohibited from holding validation authority over risks they themselves create (S. A. A. Shah et al., 2021). Empirical studies prove that the failure of this functional

demarcation cripples early detection systems and increases the vulnerability of balance sheets to financial market shocks (Sari et al., 2024).

A review of POJK Regulation Number 2 of 2024 and SEOJK Number 25 of 2023 proves the necessity of placing the treasury unit firmly on the first line of defense, while the risk management division is independent on the second line. This jurisdictional boundary reconstruction positions the treasury unit as the owner of operational business risk responsible for executing asset and liability strategies in the financial markets. The second line risk management division acts as the objective supervisor who formulates measurement methodologies, monitors limit utilization, provides independent professional challenges, and holds authority to escalate violations to the board of directors. This firm separation of roles effectively eliminates the loophole for controlling compromises in pursuit of short-term profit margins. The enforcement of these functional boundaries aligns with the integrated three-line defense model governance framework and the international prudential principles of Islamic banking (Jatmiko et al., 2023). Studies prove that second-line independence strengthens institutional solvency resilience and prevents excessive risk-taking behavior at the money market transaction table (Amiruddin et al., 2026).

The research findings identify that the governance of Islamic banking treasury has a complex dual supervision architecture not found in conventional banking systems. The operational supervision dimension not only tests financial prudential parameters but also requires an institutional sharia compliance testing process. Treasury transaction desks are not sufficient to operate under market risk limit and standard liquidity approvals. All fund placement activities, foreign exchange market transactions, and sukuk issuance must obtain a conformity opinion from the Sharia Supervisory Board as well as through monitoring by the Sharia risk management unit. This layered governance ensures that every liquidity instrument passes the validity test of ex-ante contracts before execution and ex-post compliance audits. Sharia compliance transforms into a functional barrier binding all transaction dealers. This dual governance concept is deeply rooted in the Islamic banking accountability framework, which places the sanctity of transactions on par with financial solvency (Ardianto et al., 2026).

The synthesis of POJK Policy Data Number 20 of 2025 shows a shift in the operational paradigm of treasury from merely pursuing nominal returns to fulfilling strict quantitative liquidity resilience metrics. The obligation to meet macroprudential liquidity ratios forces the treasury desk to reconfigure the composition of securities portfolios by increasing the portion of high-quality liquid assets. Decision-making on placing excess liquidity is no longer guided solely by high instrument yields, but rather takes into account market discounts, depth of secondary liquidity, and asset conversion speed when a balance sheet crisis hits. Strategic collaboration between the treasury unit and the risk management division is an absolute prerequisite in designing an integrated liquidity stress test simulation. This asset orientation restructuring gains theoretical legitimacy from the interdependence model of Islamic banking balance sheets, which proves the high sensitivity of assets to third-party funding volatility (Hamidi & Worthington, 2021). The findings of cross-border research reinforce the fact that owning quality liquid assets is a pillar supporting the resilience of Islamic banks in facing macroeconomic uncertainty turmoil (Baita et al., 2024).

Comparative results of managerial practices prove that eliminating conflicts of interest requires restructuring key performance indicators of treasury personnel from gross profit targets to risk-adjusted returns. Setting nominal profit-based targets often causes dealers to ignore risk tolerance limits and relax verification of the validity of market transaction documents. The implementation of risk-based performance metrics ensures that each personnel accounts for capital costs, exposure provisioning costs, and sharia compliance expenses at every instrument price quote. Operational accountability is strengthened through the establishment of tiered limits that include individual transaction limits, aggregate portfolio limits, and stop-loss limits monitored directly by the second line daily.

Table 1. Reconstruction Matrix of Functional Jurisdictional Demarcation of Treasury Management (First Line) and Independent Risk Management (Second Line)

Governance Dimensions	Treasury Management Unit (First Line)	Independent Risk Management Unit (Second Line)	Regulatory Parameters & Sharia Standards
Organizational Position	Business and operational functions of the balance sheet (Risk Owner & Risk Taker)	Independent supervision and compliance functions (Risk Oversight)	POJK No. 2/2024; Three-Line Defense Model (IFSB, 2021)
Main Mandates & Authorities	Execution of money market transactions, foreign exchange, liquidity management, and sukuk investments	Formulation of risk methodology, valuation validation, limit monitoring, and escalation	SEOJK No. 25/SEOJK.03/2023; Bank Risk Management Standards
Key Performance Indicators (KPIs)	Risk-based yield (RAROC), funding efficiency, and market quotation quality	Risk profile compliance, boundary violation prevention, and stress test resilience	Agency Theory; Conflict of Interest Management (Raouf & Ahmed, 2022)
Layers of Sharia Governance	Conducting transactions according to sharia product guidelines that have been approved ex-ante	Monitoring sharia compliance and non-compliance risks together with DPS and Sharia Audit	POJK No. 2/2024; AAOIFI Sharia Standards No. 21 & No. 59

Source: Synthesis of OJK Regulations, BI, IFSB Standards, and Islamic Banking Risk Management Literature (2026)

Systemic Comparison and Formulation of the Purpose-Structure-Risk-Governance (PSRG) Framework: Transformation of Prohibitions of Muamalah into Operational Parameters of the Money Market

Comparative analysis results found that Islamic banking treasury transaction practices are still trapped in a tendency of synthetic replication that mimics the pattern of conventional money market instruments mechanically. Transaction desks often package liquidity placements and foreign exchange hedging through organized tawarruq schemes solely to manipulate fixed-yield cash flows. This legalistic practice proves a shift in orientation where contract formalities are treated merely as administrative justifications to produce risk profiles identical to conventional interest instruments. The underlying transaction commodities often function only as fictitious intermediary objects without accompanied by real ownership transfers or physical asset transfers. This tendency triggers public doubt and erodes the fundamental differentiation that should be the comparative advantage of Islamic banking in the global financial market. This critical finding confirms the views of Islamic banking academics regarding the dangers of legal formalism that ignores substance *maqashid al-shari'ah* (Hassan et al., 2024). Contemporary empirical studies confirm that excessive reliance on replication instruments increases exposure to the risk of sharia non-compliance and triggers systemic institutional vulnerability (Ahmed & Sharif, 2023).

Hedging proves the fundamental difference between conventional derivative contracts and non-binding bilateral wa'ad-based sharia hedging mechanisms. Conventional derivative contracts such as

forward or foreign exchange swaps rely on future obligation exchanges that are rich in gharar elements and monetary speculation without real sector ties. The sharia hedging mechanism demands the existence of real underlying transactions and strict restrictions so that instruments are not traded on the secondary market for purely speculative purposes. This philosophical difference confirms that pure sharia hedging functions as a protective risk mitigation instrument and not as a means of arbitrage for capital gain. The prohibition of resilient foreign exchange transactions demands the presence of tangible assets and fulfillment of cash handover principles within the corridor of qabd hakiki and hukmi. These structural findings strengthen the theoretical proposition regarding the significance of separating protective risk management and money market speculation (N. Shah et al., 2023). Islamic hedging practices have proven capable of curbing exchange rate volatility without causing destabilization of financial markets (Aysan et al., 2024).

Table 1. Systemic Comparison Matrix of Money Market Architecture and Treasury Instruments: Conventional vs Substantive Sharia

Comparative Dimensions	Conventional Money Market Treasury Instruments	Substantive Sharia Treasury Instruments (PSRG-Based)
Basic Philosophy & Transaction Motives	Currency exchange for interest-based money for financial yield arbitrage and pure monetary speculation.	Liquidity intermediation based on real economic benefits (maqashid) for mitigating balance sheet mismatch risks.
Contract Architecture / Contract	Pure interest-bearing debt agreements (promissory notes, commercial paper, conventional repo, interbank lending).	Real exchange contracts (murabahah for physical commodities), profit sharing (mudharabah/musyarakah), lease of benefits (sukuk ijarah), and bilateral wa'ad.
Underlying Asset & Perpindahan Hak	Does not require physical assets; abstract financial claims are traded on a derivative basis without real asset movements.	It must be based on real assets that are halal, economically valuable, and verified by the transfer of ownership rights (qabd hakiki/hukmi).
Pricing & Yield Characteristics	Based on the market benchmark interest rate (SOFR, BI-Rate) plus credit risk premiums, discounts are continuously compounded.	Based on the agreed profit margin, the actual rental ujrah, or the profit-sharing ratio of the actual productive asset performance.
Hedging Mechanism	Forward contracts, swaps, and speculative options without real underlying assets; can be traded on the secondary market to seek gains.	Islamic Hedging instruments based on bilateral wa'ad are not binding; prohibited from trading on secondary and purely protective markets.
Balance Sheet Risk Transmission & Leverage	Creating layered leverage exposure without physical limits, increasing systemic vulnerability during monetary tightening.	Limiting leverage exposure to real asset capacity provides a natural shock absorber against capital market volatility.

Source: Synthesis of Comparative Analysis of BI Regulations, OJK, AAOIFI Standard No. 21/59, and Empirical Literature (2026).

This research successfully formulated a conceptual novelty in the form of the Purpose-Structure-Risk-Governance framework as an integrated four-dimensional operational verification parameter that transforms the prohibition of muamalah into a dealing-table decision rule. The Purpose dimension requires validation of the transaction's economic motives to ensure liquidity placement is driven by real balance sheet needs and not speculative market interest rates. The Structure dimension demands strict verification of the validity of pillars and contract conditions in a tiered manner, eliminates double-conditioned contracts, and guarantees the authenticity of underlying transaction assets. The Risk dimension establishes the integration of market risk and liquidity limits with sharia risk tolerance thresholds independently supervised by the second line. The Governance dimension ensures institutional accountability through integrated supervision by the sharia supervisory board and the internal compliance audit function. The simultaneous operationalization of these four pillars prevents the decomposition of transactions into instruments of hidden interest replication. This comprehensive framework realizes the theory of Islamic financial intermediation that demands absolute integration between legal compliance and real economic welfare (Mergaliyev et al., 2019). This holistic evaluation proves the effectiveness of the governance system in maintaining the operational integrity of Islamic banks (Sukor & Abdul Halim, 2023).

Analytical testing of the conversion mechanism of the prohibition of riba, gharar, and maisir produced a set of programmed decision rules that eliminate virtual transaction loopholes in the interbank Islamic money market. The prohibition of usury is operationalized by eliminating compound interest discount mechanisms and limiting fund placement returns based on the productive performance of the underlying assets. The prohibition of gharar is embodied in the standardization of clauses for certainty of commodity delivery, specifications of the quality of the underlying object, and the elimination of information asymmetry between liquidity transaction parties. The ban on maisir is implemented through a strict prohibition on risk transfer without real underlying assets and the closure of speculative exchange margin exchange rate transaction opportunities. This technical transformation shifts the compliance paradigm from merely formal sharia certification to quantitatively measurable preventive operational risk control. The implementation of this decision confirms the theoretical foundation of Islamic banking that demands total transparency and contractual fairness across all lines of treasury activities (Hassan et al., 2025). This standard operating system based on risk prevention rules strengthens market discipline and enhances the credibility reputation of sharia institutions in the eyes of stakeholders (Srairi et al., 2022).

Table 2. Operationalization Matrix of the Purpose-Structure-Risk-Governance (PSRG) Framework at the Sharia Treasury Dealing Table

PSRG Framework Dimensions	Operational Testing Parameters	Conversion of the Prohibition of Fiqh Muamalah	Line Control Mechanism
PURPOSE (Economic Purpose)	Transaction motive validation is driven by the real liquidity needs of the balance sheet, exchange rate protection, or halal sukuk investments.	Elimination of pure speculative motives that lead to maisir transactions and the pursuit of usury interest.	The First Line (Dealer) must include the underlying documents of the commercial transaction before the quotation.

PSRG Framework Dimensions	Operational Testing Parameters	Conversion of the Prohibition of Fiqh Muamalah	Line Control Mechanism
STRUCTURE (Keabsahan Akad)	Verification of compliance with the pillars of the contract, cancellation of double conditional contracts (shafqatayn fi shafqah), and authenticity of asset transfers.	Elimination of uncertainty of objects and prices (gharar) as well as elimination of fictitious tawarruq transactions.	First Line & Trade Automation System blocks execution if legal documents are incomplete.
RISK (Risk Mitigation)	Measurement of market risk exposure, liquidity, and exchange rate aligned with the Sharia risk tolerance limit.	Prevention of unbalanced risk accumulation and prohibition of risk diversion without productive assets.	The Second Line (Risk Management) monitors daily limit utilization, stop-loss, and integrated stress test results.
GOVERNANCE (Tata Kelola)	Layered supervision through ex-ante reviews of new products and periodic ex-post sharia compliance audits.	Maintaining the integrity of institutional trust and ensuring the purity of transactions in the eyes of the sharia public.	The Sharia Supervisory Board (DPS) and the Sharia Audit Committee evaluate operational compliance.

Source: Original Formulation of the PSRG Framework Based on the Integration of Fiqh Muamalah and Prudential Regulation (2026).

Systemic comparative evaluation proves that the integrated implementation of the Purpose-Structure-Risk-Governance framework provides superior balance sheet flexibility compared to conventional reliance on short-term interest instrument transmission. The tie-up of Islamic treasury transactions to underlying real assets can limit the uncontrolled growth of balance sheet leverage exposure during global monetary tightening cycles. The inherent risk-sharing characteristics of money market instruments based on sukuk participation and leasing create a natural shock absorber mechanism against the volatility of wholesale liquidity withdrawals. Independent supervision by the Sharia supervisory board working in parallel with the second-line risk management committee strengthens corporate governance in preventing misuse of high-risk money market instruments. This synergy in real asset governance and discipline strengthens the sustainable stability of Islamic banking amid the dynamics of regional financial market integration. The results of this study validate the resilience theory of Islamic banking balance sheets, which affirms the superiority of stability in instruments based on real assets over conventional debt mechanisms (Alqahtani & Mayes, 2023). Consistent integrated governance supervision has proven crucial in mitigating systemic banking liquidity crises (Haddad & Souissi, 2022).

4. CONCLUSION

This study proves that strengthening *the treasury governance of* Islamic banking relies on a clear functional demarcation between business risk owners in the first line and independent risk validation functions in the second line to eliminate conflicts of interest. This governance reconstruction is reinforced by integrated dual supervision and the implementation of the *Purpose-Structure-Risk-Governance* framework that converts *fiqh muamalah principles* into operational decision rules, mandates

the existence of real underlying assets, and limits bilateral wa'ad-based hedging to prevent synthetic replication of conventional interest instruments. Practically, regulatory authorities need to codify this framework into Islamic money market standards, while bank management is encouraged to align dealer performance indicators with risk-based returns and automate digital verification of basic transaction documents. Further research is recommended to quantitatively test the impact of treasury function segregation on the solvency resilience of Islamic banks and conduct comparative studies across regional jurisdictions.

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