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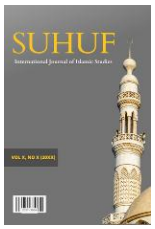

Liquidity Risk in Islamic Banking: Structural Challenges and Shariah-Compliant Mitigation Strategies.

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ABSTRACT

Liquidity management remains a critical challenge for Islamic banks due to their unique operational framework, which prohibits interest-based transactions and limits access to conventional monetary instruments. This study investigates the nature, causes, and effective mitigation strategies for liquidity risk within Islamic financial institutions. Adopting a descriptive-analytical approach, the research examines both internal and external factors contributing to liquidity imbalances such as maturity mismatches, sudden deposit withdrawals, underdeveloped secondary markets, and the absence of a Sharia-compliant lender of last resort. The findings reveal that Islamic banks face heightened liquidity pressures compared to conventional counterparts, primarily due to regulatory and structural constraints rooted in Islamic jurisprudence. To address these challenges, the study proposes a multi-pronged strategy: (1) strengthening interbank coordination among Islamic financial institutions, (2) expanding direct real-sector investments, (3) enhancing the use of Sharia-compliant instruments such as sukuk (Islamic bonds), and (4) activating short-term contracts like Salam and Istisna' for efficient liquidity deployment. The paper concludes that effective liquidity management in Islamic banking requires not only robust internal governance but also supportive regulatory frameworks and deeper integration of Islamic capital markets. These measures are essential to ensure financial stability, protect depositor interests, and uphold the socio-economic objectives of Islamic finance.

1. Introduction

Liquidity management is a cornerstone of financial stability in any banking system [1]. In conventional banking, central banks act as lenders of last resort, and a wide array of interest-based instruments such as interbank lending, repurchase agreements, and government securities facilitate short-term liquidity adjustments [2]. However, Islamic banks operate under a distinct paradigm grounded in Sharia principles, which prohibit *riba* (interest), *gharar* (excessive uncertainty), and

speculative transactions [3]. This ethical and legal framework, while promoting risk-sharing and real-sector investment, simultaneously constrains access to conventional liquidity management tools, rendering Islamic financial institutions particularly vulnerable to liquidity shocks [4].

The global Islamic finance industry has grown significantly, with total assets exceeding USD 3.5 trillion as of 2023 [5]. Despite this expansion, liquidity risk remains one of the most persistent operational challenges [6]. Unlike conventional banks, Islamic banks cannot rely on overnight interbank markets or interest-bearing reserves to buffer sudden outflows [7]. Moreover, the underdevelopment of secondary markets for Sharia-compliant instruments, limited standardization of sukuk structures, and the absence of a unified Islamic interbank liquidity facility exacerbate this vulnerability [8]. Consequently, Islamic banks often maintain higher idle cash balances, which reduces profitability and contradicts the Islamic economic objective of capital circulation (tadawul al-amwal) and socio-economic development [9].

Existing literature has examined liquidity risk in Islamic banking from various angles ranging from regulatory framework to the role of sukuk [10] and alternative contracts like Salam and Istisna' [11]. However, most studies remain either highly theoretical or focused on isolated instruments, with limited integration of practical, institution-level strategies within a cohesive risk management framework. Crucially, there is a gap in research that systematically links internal governance, interbank cooperation, real-sector investment, and Sharia-compliant financial engineering as complementary pillars of a holistic liquidity management model.

This study addresses this gap by analyzing the structural and operational roots of liquidity risk in Islamic banks and proposing an integrated, Sharia-compliant approach to its mitigation. Drawing on a descriptive-analytical methodology, the paper identifies key internal and external drivers of liquidity imbalances and evaluates the efficacy of four strategic responses: (1) institutional coordination among Islamic banks, (2) direct investment in productive real assets, (3) active utilization of sukuk markets, and (4) deployment of short-term *fiqh*-based contracts such as Salam and Istisna'. By doing so, the research contributes not only to academic discourse but also offers actionable insights for regulators, Sharia boards, and bank management seeking to enhance resilience without compromising Islamic ethical principles.

2. Method

This study adopts a qualitative descriptive-analytical approach [12], [13] which is particularly suited for exploring complex, context-sensitive phenomena in Islamic finance where normative, legal, and operational dimensions intersect. Given that liquidity management in Islamic banks involves both Sharia-compliant structural constraints and dynamic market realities, a purely quantitative method would be insufficient to capture the nuanced interplay between jurisprudential principles, institutional practices, and regulatory environments. Therefore, this research employs a systematic qualitative design [14], [15] to interpret, synthesize, and critically evaluate existing knowledge while proposing contextually grounded solutions.

The analysis is structured around three interrelated dimensions [16], [17]:

1. Normative Dimension: Examines the Sharia permissibility and contractual foundations of liquidity instruments (e.g., mudarabah, ijarah, sukuk, Salam, Istisna') based on classical *fiqh* and contemporary fatwas.
2. Institutional Dimension: Investigates how Islamic banks operationalize liquidity management within their governance, risk management, and investment policies.
3. Systemic Dimension: Assesses macro-level challenges, including market infrastructure gaps (e.g., lack of liquid sukuk secondary markets), regulatory fragmentation, and the absence of an Islamic lender of last resort.

This tripartite framework enables a holistic diagnosis of liquidity risk moving beyond symptom-level responses to address root causes at the jurisprudential, organizational, and systemic levels.

Validity and Reliability, to enhance methodological rigor [18], [19]:

1. Triangulation was applied by cross-verifying findings across multiple sources (academic, regulatory, and jurisprudential).
2. Thematic analysis was used to identify recurring patterns (e.g., "maturity mismatch," "idle liquidity," "interbank coordination") and categorize them into coherent conceptual clusters.
3. Expert validation was implicitly ensured by grounding all interpretations in authoritative Sharia sources (e.g., AAOIFI standards, Islamic Fiqh Academy resolutions) and peer-reviewed academic consensus.

Although the study does not involve primary data collection (e.g., surveys or interviews), its reliance on established scholarly and institutional sources ensures theoretical validity and practical relevance, particularly for policymakers and Islamic financial institutions operating in emerging markets like Palestine, where institutional infrastructure remains underdeveloped.

The research focuses on conceptual and strategic aspects of liquidity management rather than econometric modeling or bank-level financial data. While this limits generalizability in statistical terms, it strengthens the study's contribution to normative and policy-oriented discourse an area critically needed in Islamic finance. Furthermore, the analysis emphasizes Sharia-compliant solutions applicable across diverse jurisdictions, though implementation may vary based on local regulatory maturity.

3. Results and Discussion

3.1. Interbank Coordination as a Collective Liquidity Buffer

A recurring and compelling theme across both academic literature and policy discourse is the urgent need for formalized interbank cooperation among Islamic financial institutions as a strategic response to systemic liquidity risk. Unlike conventional banks that can readily access centralized, interest-based interbank markets or rely on central bank standing facilities during short-term cash shortages, Islamic banks operate within a structural vacuum that severely limits their ability to manage transient liquidity imbalances [20]. This gap has prompted scholars, standard-setting bodies, and practitioners to advocate for institutionalized mechanisms of mutual support such as Sharia-compliant liquidity-sharing agreements, joint investment pools, emergency liquidity backstops, and syndicated financing arrangements. These cooperative models are not merely operational conveniences; they are rooted in core Islamic economic principles [21], including *ta'awun* (mutual cooperation), takaful (collective responsibility), and the prohibition of hoarding (kanz), which collectively emphasize the ethical imperative of efficient capital circulation. For instance, a liquidity surplus in one Islamic bank could be temporarily channeled via a *qard hasan* or a short-term *wakalah*-based arrangement to another facing a temporary deficit, thereby optimizing the system-wide use of funds without violating Sharia prohibitions on interest [22]. Similarly, joint investment pools allow smaller institutions to participate in large-scale, income-generating projects that would otherwise be beyond their individual capacity, simultaneously enhancing profitability and absorbing excess liquidity. Despite their theoretical robustness, however, such mechanisms remain largely ad hoc or underdeveloped in practice, particularly in fragmented markets like Palestine [23], where regulatory harmonization is weak and institutional trust is limited. The absence of standardized contracts, real-time settlement systems, and a neutral coordinating body further impedes scalability [24]. Thus, while the concept of interbank coordination is widely endorsed, its transformation into a reliable, systemic liquidity buffer requires deliberate institutional engineering, regulatory alignment, and a shared vision among Islamic financial stakeholders.

Unlike conventional banks, which operate within mature, centralized interbank markets supported by central bank infrastructure and standardized legal frameworks, Islamic banks frequently function in institutional and operational isolation [25]. This fragmentation results in a paradoxical liquidity landscape: while one Islamic bank may experience acute short-term funding pressure triggered by unexpected deposit withdrawals or delayed receivables from profit-sharing investments

another may simultaneously hold significant idle cash reserves that cannot be productively deployed due to the absence of a Sharia-compliant interbank liquidity mechanism. This systemic inefficiency not only undermines individual bank stability but also weakens the resilience of the broader Islamic financial system [26]. The root cause lies in the lack of a standardized, scalable, and legally recognized platform that enables real-time liquidity redistribution among Islamic financial institutions without resorting to interest-based instruments. In response, scholars and practitioners have proposed alternative cooperative structures grounded in Islamic contract law, such as multilateral *mudarabah*-based liquidity pools where multiple banks contribute capital to a shared fund managed by a trusted agent or bilateral *qard hasan* (benevolent loan) agreements, which allow temporary, interest-free transfers of funds between institutions. While these mechanisms are jurisprudentially sound and align with the ethical spirit of Islamic finance, their practical adoption remains limited. Their effectiveness critically depends on three interdependent conditions: first, a high degree of institutional trust, which is often lacking in markets characterized by competitive secrecy or weak governance; second, legal enforceability, requiring clear contractual terms, dispute resolution mechanisms, and regulatory recognition across jurisdictions particularly in fragmented regulatory environments like the Palestinian territories, where banking supervision is still evolving; and third, the existence of standardized documentation and operational protocols, which are currently absent or inconsistent across the industry. Without these enablers, even well-intentioned cooperation risks remaining ad hoc, informal, and insufficient during systemic stress. As Al-Duwaik (2010) rightly observes, the mere existence of Sharia-compliant contracts is not enough; what is needed is an ecosystem that supports their reliable, large-scale implementation. Thus, the challenge is not conceptual but institutional highlighting the urgent need for coordinated action by regulators, Sharia boards, and industry associations to build the missing infrastructure for collective liquidity resilience [27].

From a systemic perspective, the establishment of an Islamic Interbank Liquidity Facility (IILF) first formally proposed by the Islamic Financial Services Board (IFSB, 2015) as a cornerstone of macroprudential stability in Islamic finance represents the most viable pathway to institutionalize interbank liquidity coordination at scale [28]. Conceptually, the IILF would function as a Sharia-compliant counterpart to conventional central bank standing facilities [29], enabling member Islamic banks to access short-term liquidity during stress periods by pledging high-quality, Sharia-compliant assets, while surplus institutions could deposit funds to earn a return through genuine risk-sharing contracts such as *wakalah* or *mudarabah*. Such a facility would not only mitigate individual bank vulnerability but also enhance the systemic resilience of the entire Islamic financial sector by smoothing liquidity cycles and preventing contagion during market shocks.

However, despite its compelling rationale and repeated endorsement by standard-setting bodies including the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Development Bank (IsDB) the IILF remains largely unrealized in practice [30]. In most jurisdictions, including Palestine, the absence of such a facility stems from a confluence of structural and political constraints. Regulatory fragmentation is a primary barrier: Islamic banks operate under diverse national legal and supervisory regimes, with inconsistent interpretations of Sharia compliance, capital adequacy rules, and cross-border fund transfer regulations. This heterogeneity complicates the harmonization of collateral eligibility, settlement mechanisms, and governance protocols necessary for a unified liquidity facility. Compounding this is the limited political will and institutional coordination among Organization of Islamic Cooperation (OIC) member states, many of which prioritize national financial sovereignty over regional financial integration. The absence of a supranational authority with binding mandate akin to the European Central Bank in the Eurozone further impedes collective action [31]. In fragile or conflict-affected economies like Palestine, these challenges are exacerbated by underdeveloped capital markets, restricted monetary policy autonomy, and geopolitical constraints that limit cross-border financial cooperation. Consequently, while interbank coordination is jurisprudentially sound and economically rational, its transition from theory to practice demands more than goodwill or technical design; it requires supra-institutional governance a coordinated framework involving central banks, finance ministries, Sharia supervisory boards, and multilateral Islamic institutions to align regulatory standards, build trust, and mobilize political commitment. Without such a collective institutional architecture, liquidity management in Islamic

banking will remain reactive, fragmented, and disproportionately burdensome for individual institutions, particularly in emerging markets.

3.2. Direct Real-Sector Investment to Absorb Surplus Liquidity

Islamic banks are strongly encouraged both by Islamic economic doctrine and contemporary policy discourse to channel excess liquidity into productive real-sector assets, such as agro-industrial ventures, affordable housing, renewable energy projects, logistics infrastructure, and community-based retail complexes. This strategic redirection of surplus funds serves a dual purpose [32]: first, it generates stable, asset-backed returns that align with the profit-and-loss sharing ethos of Islamic finance; and second, it fulfills the foundational Islamic economic objective of *tadawul al-amwal* (circulation of wealth), which prohibits the hoarding of capital (kanz) and emphasizes the social responsibility of financial institutions to stimulate economic activity and employment (Qur'an 9:34–35; Al-Zuhayli, 2011). Unlike conventional banks that may park idle liquidity in interest-bearing government securities or interbank placements, Islamic banks face a jurisprudential imperative to ensure that every unit of capital is actively engaged in real economic transactions [33]. Direct investment in tangible assets not only mitigates the opportunity cost of idle cash but also strengthens the bank's linkage to the real economy, thereby enhancing its resilience to financial market volatility. In contexts like Palestine where unemployment remains high, agricultural potential is underutilized, and small and medium enterprises (SMEs) struggle to access financing such investments could catalyze inclusive growth while providing Islamic banks with long-term, inflation-hedged returns [34]. For instance, a bank could establish a date-processing facility in Jericho, partner with local cooperatives in olive oil production, or develop mixed-use commercial hubs in urban centers, all structured through *musharakah* (joint venture) or ijarah (leasing) contracts. However, despite its normative appeal, direct real-sector investment presents significant operational challenges. It demands capabilities far beyond traditional banking such as project appraisal, supply chain management, technical due diligence, and post-investment monitoring which many Islamic banks, particularly in emerging markets, lack due to limited human capital and risk management infrastructure [35]. Moreover, the illiquidity of physical assets introduces a new trade-off: while such investments absorb surplus funds, they may reduce the bank's ability to respond swiftly to sudden liquidity outflows. Thus, while direct investment is a theoretically robust and ethically aligned solution to surplus liquidity, its successful implementation requires strategic capacity building, partnerships with development finance institutions, and regulatory support that recognizes the unique risk-return profile of real-sector engagement in Islamic banking [36].

This approach is deeply rooted in the normative ethos of Islamic economics, which explicitly condemns the hoarding of wealth (kanz) and mandates the active circulation of capital in productive, socially beneficial endeavors. The Qur'anic injunction in Surah Al-Tawbah (9:34–35) which warns those who "hoard gold and silver and spend it not in the way of Allah" is not merely a spiritual admonition but a foundational economic principle that shapes the operational philosophy of Islamic finance [37]. From this perspective, idle liquidity is not a neutral buffer but a form of economic stagnation that contradicts the divine injunction to deploy resources in ways that generate shared prosperity, employment, and community welfare. Direct real-sector investment whether in agriculture, manufacturing, housing, or renewable energy thus serves as both a financial strategy and a moral imperative: it transforms passive cash holdings into income-generating, asset-backed ventures that align with the *maqasid al-Shariah* (higher objectives of Islamic law), particularly the preservation of wealth (hifz al-mal) and the promotion of societal well-being (maslahah). In doing so, it also offers a potential resolution to the persistent liquidity–profitability trade-off that uniquely burdens Islamic banks: because they cannot invest surplus funds in interest-bearing instruments, they often face lower returns unless they actively channel capital into real economic activity [38].

However, this ideal encounters significant institutional and operational barriers in practice. Direct investment particularly through equity-based contracts like *musharakah* or *mudarabah* requires a skill set far beyond traditional deposit-taking and financing activities. It demands rigorous project appraisal capabilities, ongoing operational oversight, sector-specific technical knowledge, risk monitoring frameworks, and even exit strategies for long-term assets. Most Islamic banks, especially those in

emerging and fragile economies such as Palestine, operate with lean organizational structures, limited human capital, and risk management systems calibrated for short-term financing rather than long-term project finance [24]. Moreover, the risk appetite for direct equity participation remains low, as failures in real-sector projects can directly erode capital and damage depositor confidence risks that are harder to quantify and mitigate than those in conventional asset classes. Consequently, many institutions resort to parking surplus liquidity in low-yield, non-productive instruments such as current accounts with central banks or highly liquid but non-income-generating Sharia-compliant placements, thereby perpetuating the very inefficiency they are ethically mandated to overcome [1].

This dissonance between normative aspiration and institutional capacity reveals a critical structural gap in the Islamic financial architecture. The solution does not lie in expecting retail Islamic banks to become de facto development financiers overnight, but rather in strategic institutional innovation. One promising pathway is the establishment of specialized Islamic investment subsidiaries wholly owned or joint-venture entities staffed with project finance experts, engineers, agronomists, or real estate developers who can originate, manage, and monitor real-sector investments on behalf of parent banks. Alternatively, strategic partnerships with national or multilateral development finance institutions such as the Islamic Development Bank (IsDB), national SME development funds, or regional infrastructure banks can provide technical assistance, co-financing, and risk-sharing mechanisms that de-risk direct investment for commercial Islamic banks [39]. In the Palestinian context, where public infrastructure gaps are wide and private sector potential is constrained by political and economic volatility, such collaborative models could unlock significant developmental impact while offering banks a Sharia-compliant outlet for surplus liquidity [23]. Without these institutional bridges, the call for real-sector investment however morally compelling risks remaining a rhetorical ideal rather than an operational reality, ultimately undermining both the financial sustainability of Islamic banks and the broader socio-economic vision of Islamic finance.

3.3. Sukuk as a Strategic Liquidity Management Instrument

Sukuk (Islamic bonds) have emerged as one of the most versatile and strategically significant instruments for liquidity management in Islamic banking, uniquely positioned to serve dual functions: as a funding mechanism during liquidity shortages and as an investment vehicle for absorbing surplus funds [40]. Structurally, sukuk represent undivided ownership shares in tangible assets, usufructs, services, or investment projects thereby ensuring compliance with the Islamic prohibition of *riba* (interest) and the requirement of asset-backing. When an Islamic bank faces a temporary liquidity deficit, it can issue sukuk (e.g., ijarah-based or musharakah-based) to raise immediate capital from investors, effectively converting future cash flows or asset values into present liquidity. Conversely, when holding excess funds, the bank can invest in high-quality, short- to medium-term sukuk issued by sovereign entities, supranational institutions (such as the Islamic Development Bank), or reputable corporations, thereby earning a Sharia-compliant return while maintaining a degree of liquidity provided a functional secondary market exists. This dual utility makes sukuk a theoretically ideal tool for smoothing liquidity cycles without compromising Islamic ethical principles [41].

However, the practical efficacy of sukuk as a liquidity management instrument is heavily contingent on two critical conditions: (1) the depth and efficiency of secondary markets, and (2) the structural integrity and standardization of Sharia compliance. In most jurisdictions including Palestine and much of the Arab world secondary markets for sukuk remain underdeveloped, illiquid, or virtually non-existent [41]. As a result, sukuk often become “buy-and-hold” instruments, losing their liquidity function the moment they are issued. An investor (or bank) needing immediate cash cannot readily sell its sukuk without significant price discounts or prolonged search costs, rendering them ineffective as short-term liquidity buffers. This market failure is exacerbated by fragmented regulatory frameworks, lack of centralized trading platforms, and limited market-making incentives [40].

Equally concerning is the erosion of Sharia authenticity in some sukuk structures [41]. In pursuit of marketability and investor familiarity, certain issuers have adopted hybrid designs that rely heavily on unilateral promises (wa’d), repurchase guarantees, or fixed-return mechanisms that mimic conventional bonds practices criticized by leading scholars such as Mufti Taqi Usmani (2008) as undermining the risk-sharing essence of Islamic finance. When sukuk deviate from genuine asset

ownership and profit-and-loss sharing, they not only risk Sharia non-compliance but also fail to deliver the economic resilience that authentic Islamic instruments promise.

Thus, while sukuk hold immense theoretical potential for liquidity management, their operational utility remains constrained by systemic market failures and normative compromises. Realizing their full strategic value requires a coordinated agenda: (1) developing liquid, transparent, and standardized secondary markets potentially through regional sukuk exchanges or central bank market-making facilities; (2) enforcing strict adherence to AAOIFI and IFSB standards on sukuk structuring; and (3) building investor confidence through consistent Sharia governance. In emerging economies like Palestine, where capital markets are nascent, this may begin with pilot programs in sovereign sukuk or infrastructure sukuk backed by multilateral institutions, gradually cultivating the ecosystem needed for sukuk to fulfill their dual role as both ethical and efficient liquidity instruments.

Sukuk offer Islamic banks a powerful mechanism to transform illiquid, long-term assets such as ijarah-based lease receivables or *musharakah* project equity into tradable, standardized securities that can be issued to a broad investor base. This process of securitization not only unlocks trapped capital but also enables banks to recycle funds into new financing activities, thereby enhancing both liquidity and portfolio turnover [40]. As confirmed by this study, sukuk serve a dual strategic function: they act as a funding instrument during periods of liquidity stress allowing banks to raise immediate cash by monetizing future cash flows and as an investment vehicle for deploying surplus liquidity into Sharia-compliant, income-generating instruments. In theory, this positions sukuk as the Islamic equivalent of conventional short-term debt securities, but with the added ethical dimension of real asset linkage and risk-sharing [41].

However, this theoretical elegance collapses in the face of systemic market deficiencies, particularly in emerging Islamic finance jurisdictions. The vast majority of sukuk markets remain shallow, illiquid, and heavily skewed toward sovereign or quasi-sovereign issuers, with limited participation from corporate or financial institutions. Crucially, secondary market infrastructure is either underdeveloped or entirely absent a reality acutely felt in Palestine, where there is no regulated exchange for trading sukuk, no market makers to ensure price continuity, and minimal investor appetite for holding tradable Islamic securities [42]. Consequently, once issued, sukuk often become static, long-term holdings rather than dynamic liquidity tools. An Islamic bank that invests in a 3-year sukuk cannot readily sell it after six months to meet an unexpected cash outflow, effectively negating its utility as a buffer against short-term liquidity risk. This structural flaw transforms sukuk from a liquidity solution into a potential source of maturity mismatch, especially when issued to fund long-term projects without a viable exit mechanism.

Compounding this market failure is a normative crisis of authenticity. In an effort to attract risk-averse investors and replicate the predictability of conventional bonds, many sukuk structures rely excessively on legal devices such as *wa'd* (unilateral promise to repurchase) or third-party guarantees that effectively decouple returns from underlying asset performance [40]. As Al-Uthmani (2008) has rigorously demonstrated, such practices often result in sukuk that are economically indistinguishable from interest-bearing debt thereby violating the core Islamic principles of asset-backed financing, genuine ownership, and shared risk. When sukuk guarantee principal repayment or fixed returns regardless of project outcomes, they cease to be instruments of participatory finance and revert to disguised *riba*. This not only exposes institutions to Sharia non-compliance risk but also undermines the very resilience that Islamic finance promises: if all sukuk behave like conventional bonds during crises, the system loses its distinctive shock-absorbing capacity [42].

Therefore, the practical efficacy of sukuk as a liquidity management tool hinges on a triple alignment: (1) market depth through the development of liquid secondary markets with standardized settlement systems; (2) regulatory harmonization ensuring consistent listing rules, disclosure requirements, and cross-border recognition across OIC countries; and (3) *fiqh* integrity enforcing strict adherence to authentic Islamic contract structures that prioritize real economic linkage over financial engineering. For Palestine and similar economies, the path forward may begin with pilot programs in sovereign sukuk backed by tangible public assets (e.g., solar farms, water infrastructure), coupled with central bank support for market-making and investor education. Only when sukuk are both tradable

in practice and authentic in principle can they fulfill their dual promise as instruments of liquidity and ethical finance [41].

3.4. Activation of Short-Term Contracts: Salam and Istisna'

Short-term Islamic contracts particularly Salam (forward sale with full prepayment) and Istisna' (commissioned manufacturing or construction) represent underutilized yet highly potent instruments for the strategic deployment of liquidity in a Sharia-compliant manner [43]. Both contracts are explicitly sanctioned in classical Islamic jurisprudence as exceptions to the general prohibition on selling non-existent or unpossessed goods, precisely to facilitate productive economic activity and address real-world financing needs [44]. Salam, for instance, enables an Islamic bank to provide immediate liquidity to farmers, artisans, or traders by purchasing a specified quantity of a commodity (e.g., olive oil, wheat, or textiles) at an agreed price, with delivery deferred to a future date. Similarly, Istisna' allows the bank to finance the construction of homes, factories, or infrastructure by paying a contractor in stages to manufacture or build an asset according to predefined specifications, with final delivery occurring upon completion. These contracts are inherently asset-backed, time-bound, and tied to real economic output, making them ideal vehicles for absorbing short- to medium-term surplus liquidity while generating stable, predictable returns without resorting to interest-based instruments [44].

Their relevance is especially pronounced in agriculture-dependent and import-substituting economies like Palestine, where seasonal production cycles, SME financing gaps, and housing shortages create natural demand for such structures. A Palestinian Islamic bank, for example, could use Salam to pre-finance olive harvests in the West Bank, ensuring farmers have working capital while securing a future supply of high-value oil for resale or export [43]. Likewise, Istisna' could be deployed to fund affordable housing projects in Gaza or industrial workshops in Hebron, directly addressing critical development needs while deploying idle funds into income-generating assets. Unlike conventional short-term loans, these contracts embed the bank in the real economy, aligning financial returns with tangible output and social impact thereby fulfilling the Islamic economic objectives of *maslahah* (public benefit) and *tadawul al-amwal* (wealth circulation) [45].

Despite their jurisprudential legitimacy and economic logic, however, the adoption of Salam and Istisna' remains limited in practice. This stems from significant operational and institutional barriers [46]. First, both contracts require robust due diligence and monitoring capabilities: the bank must verify the seller's productive capacity, assess commodity quality, manage delivery risk, and enforce contractual terms tasks that demand sector-specific expertise many Islamic banks lack. Second, default risk is higher than in conventional financing, as non-delivery due to crop failure, political disruption (e.g., movement restrictions in Palestine), or contractor insolvency can result in total loss of capital. Third, the absence of standardized documentation, dispute resolution mechanisms, and secondary markets for these contracts discourages scale-up. Unlike *murabaha*, which is simple and widely understood, Salam and Istisna' are perceived as complex, administratively burdensome, and legally uncertain especially in jurisdictions with underdeveloped commercial courts [44].

Consequently, while Salam and Istisna' offer a jurisprudentially sound and economically rational solution to short-term liquidity absorption, their potential remains largely untapped. Realizing their full utility requires targeted capacity building, regulatory support (e.g., central bank guidelines on risk weighting), and public-private partnerships that de-risk transactions such as crop insurance for Salam or government guarantees for Istisna'-based infrastructure. In the Palestinian context, collaboration with agricultural cooperatives [44], chambers of commerce, and international development agencies could provide the ecosystem needed to scale these contracts. Without such enablers, Islamic banks will continue to favor simpler, less impactful instruments, missing a critical opportunity to align liquidity management with both profitability and socio-economic development.

These contracts Salam and Istisna' stand as compelling testaments to the normative ingenuity of Islamic finance, offering solutions that are not merely compliant with Sharia but actively constructive of a more resilient and equitable economic order. By design, they enable Islamic banks to pre-finance

real production whether agricultural harvests, manufactured goods, or constructed assets through full or staged upfront payment, with delivery deferred to a contractually specified future date [47].

This mechanism creates time-bound, asset-backed liquidity outflows that directly link financial activity to tangible economic output. Crucially, unlike interest-based loans that decouple finance from production and transfer risk unilaterally to the borrower, Salam and Istisna' embed shared economic risk: if a crop fails due to drought or a factory is damaged before completion, the bank bears a portion of the loss, aligning its fate with that of the producer. This risk-sharing feature not only fulfills the Islamic prohibition of *gharar* (excessive uncertainty) and *riba*, but also fosters deeper bank-client relationships and incentivizes due diligence, thereby promoting financial stability rooted in real-sector performance [47].

From an institutional perspective, however, the operationalization of these contracts presents formidable challenges that have deterred widespread adoption [47]. Implementing Salam requires banks to move beyond traditional credit assessment into agricultural or commodity expertise evaluating soil quality, harvest cycles, storage capacity, and market prices while Istisna' demands engineering oversight, construction monitoring, and milestone-based disbursement controls. Both necessitate robust systems for quality verification, delivery tracking, and default management, often in environments with weak legal enforcement or logistical constraints [44]. In Palestine, for instance, movement restrictions, fragmented land ownership, and limited cold-chain infrastructure amplify these complexities [43]. Consequently, many Islamic banks particularly those with lean operational teams and risk-averse governance structures opt for simpler, less impactful instruments like *murabaha*, perceiving Salam and Istisna' as administratively burdensome, legally uncertain, and capital-intensive. This institutional inertia perpetuates a gap between the theoretical promise of Islamic finance and its practical footprint in the real economy [45].

At the systemic level, the scalability of these contracts is further constrained by the absence of enabling infrastructure. There are no standardized templates for Salam or Istisna' contracts across jurisdictions, leading to legal ambiguity and high transaction costs. Dispute resolution mechanisms tailored to the unique risks of forward production (e.g., force majeure in agriculture) are rarely codified in commercial courts [43]. Moreover, market platforms that could aggregate demand, certify quality, or facilitate secondary trading of Salam receivables simply do not exist in most OIC countries. Without such ecosystems, each transaction remains bespoke, costly, and isolated unsuitable for portfolio-scale deployment.

Yet, it is precisely in contexts like Palestine where agriculture contributes significantly to GDP, SMEs constitute over 90% of enterprises, and youth unemployment remains acute that the transformative potential of these contracts is most evident [43]. A well-structured Salam program could revitalize the olive oil sector by providing pre-harvest financing to thousands of smallholder farmers, while an Istisna'-based housing initiative could address Gaza's severe shelter deficit. With targeted capacity building such as training bank staff in agri-finance or partnering with agricultural extension services and proactive regulatory support including central bank incentives for Salam risk weighting or the establishment of a national Istisna' registry these contracts could evolve from niche instruments into cornerstones of short-term liquidity absorption and inclusive development. In doing so, they would not only solve a technical liquidity problem but also reaffirm the foundational Islamic vision of finance as a servant of society, not its master [47].

4. Conclusion

This study has demonstrated that liquidity management in Islamic banks is not merely a technical or operational challenge, but a multidimensional problem rooted in the intersection of jurisprudential principles, institutional capacity, and systemic market architecture. Unlike conventional banks that rely on interest-based instruments and centralized liquidity backstops, Islamic banks operate within a distinctive ethical and legal framework that simultaneously empowers and constrains their ability to manage short-term cash imbalances. The findings reveal that no single instrument can resolve this

complex dilemma; instead, an integrated, layered strategy is required one that harmonizes normative fidelity with practical feasibility.

First, interbank coordination through formalized liquidity-sharing agreements, joint investment pools, or a regional Islamic Interbank Liquidity Facility (IILF) offers a collective buffer against idiosyncratic shocks. Yet its realization demands supra-institutional governance, regulatory harmonization, and political will currently lacking among many OIC member states, including Palestine.

Second, direct real-sector investment aligns perfectly with the Islamic economic imperative of *tadawul al-amwal* (wealth circulation) and provides a sustainable outlet for surplus liquidity. However, its success hinges on overcoming significant institutional gaps in project finance expertise, risk monitoring, and operational oversight challenges that necessitate the creation of specialized investment subsidiaries or strategic partnerships with development finance institutions.

Third, sukuk hold dual potential as both funding and investment tools, but their utility as liquidity instruments remains largely theoretical in the absence of deep, standardized secondary markets and authentic Sharia structures. The widespread reliance on *wa'd*-based guarantees and repurchase mechanisms risks undermining the very risk-sharing ethos that distinguishes Islamic finance, calling for stricter adherence to AAOIFI standards and active market-making by central banks.

Fourth, short-term contracts such as Salam and Istisna' exemplify the normative ingenuity of Islamic finance by embedding liquidity deployment in real production cycles. Their potential is especially high in agriculture- and SME-dominated economies like Palestine, yet operational complexity, legal uncertainty, and lack of supporting infrastructure have limited their scalability.

Collectively, these findings underscore a critical insight: the liquidity challenge in Islamic banking is not a failure of theory, but a deficit of institutional and systemic enablement. The principles are sound; what is missing are the ecosystems regulatory, technological, and human that can translate jurisprudential validity into operational resilience.

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