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The Financial Performance and Credit Risk Management of Islamic Banks

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Abstract. This paper investigates the effect of credit risk management on the financial performance of Islamic banks in Jordan in the context of a sample of employees of five Islamic banks. The demographic data showed that the majority of the respondents were in the 31–40 years age group (39.2%) and male (66.7%) and bachelor's degree holders (62.9%) Credit risk management (4.1) and capital adequacy (4.2). The mean score for all the dimensions was between 4 and 5 reflecting a higher position. The time to get a loan approved was rated mid-size (3.5) – indicating operational improvement potential. The findings revealed a substantial positive correlation between credit risk management variables and financial performance indicators, with ROA at 0.72 and ROE at 0.68. The resource for performing structural equation modeling (SEM) confirmed the positive relationship between credit risk management and financial performance, with fit indices CFI = 0.95 and RMSEA = 0.05 suggesting a good fit. The above findings highlighted the importance of effective credit risk management practices to improve Islamic banks' financial performance and financial soundness. The study recommends improving their training programs, streamlining loan approval processes, increasing reliance on FinTech, ensuring compliance, aiming for diversification, strengthening customer relationship management, and carrying out regular risk assessments. Possible studies in the future are to investigate the impact of new financial technologies and the regulatory alterations impact on Islamic banks' credit risk management practices worldwide.

Keywords: Credit risk, Financial performance, Islamic banks, Jordan.

1. INTRODUCTION

Islamic banks consider credit risk management as their top priority. Islamic banks uniquely differ in all aspects of the bank they also obey Islamic principles (Firdaus, 2023). The financing disbursed by banks may be affected by both systematic and unsystematic factors, and then banks have to face the risk of disbursed financing (N. Khan et al., 2023). Credit risk management is very necessary for the sustainability and stability of Islamic banks' operations (Kusnandar, 2022). So Islamic banks have shown to be more effective in credit risk management and practices generally terms than traditional banks (Mahfod Aldoseri & Worthington, 2022). Organizations like the Accounting and Auditing Organization for Islamic Financial Institutions and the Islamic Financial Services Board, which provide external assistance also make contributions to these advantages (Yusoff et al., 2023). In general, credit risk management is essential in reducing risk and safety for Islamic banks' operations.

Informed and predicted the factors affecting the financial performance management of Islamic banks. S. Khan et al., (2023) All of the latent variables have a significant indirect relationship with total assets, bank size, liquidity, asset quality, capital adequacy ratio, and operational efficiency. Intellectual capital (IC) is also known to influence the financial performance of Islamic banks, particularly profitability (Asutay & Ubaidillah, 2023). There is also a difference in the performance level between the two groups of banks measured from CAR, NPL/NPF, and LDR/FDR ratios (Wulansari et al., 2023). In terms of Islamic banking performance, studies have concluded that FinTech startups negatively affect overall bank performance but may have a positive effect on bank performance when interacting with Islamic banks, particularly for peer-to-peer lending types of FinTechs (Yudaruddin, 2023). Over the short and long run, the profitability of Islamic banks is significantly affected by management decision variables, as well as variations in the macroeconomic environment, and capital, asset quality, efficiency, and bank size are the most important determinants of Islamic banks' profitability (Jallow, 2022).

Many papers have explored the relationship between credit risk management and the financial performance of Islamic banks. According to one study, credit risk in banks is better managed with better practices in Saudi Arabia for Islamic banks than for conventional banks (Qela, 2023). A separate study demonstrated that Islamic banks on average have lower levels of nonperforming loans compared to conventional banks, suggesting a balance between limiting credit risk and increasing business risk (Kusnandar, 2022). Also, it was revealed that Islamic banks have greater uncertainty in their returns on assets compared to conventional banks because of their higher operational cost (Wulansari et al., 2023). The results of our research indicate that the Islamic bank type appears to be less favorable with regards to business risk, and consequently shows more instability of financial condition between Islamic bank companies in Indonesia. This paper aims to analyze the impact of credit risk management systems on the performance of Islamic banks.

2. LITERATURE REVIEW

In Islamic banks, the concept of credit risk management in Islamic banks is identifying, assessing, and monitoring of risk of the financing activity (Kusnandar, 2022). It is apparent that Islamic banks have a separate risk profile presenting their own set of unique challenges and the evidence reflects that Saudi Arabian Islamic banks demonstrate superior credit risk management practices than their conventional bank counterparts (Mahfod Aldoseri & Worthington, 2022). Security package Credit risk and liquidity risk risk management of Islamic microfinance institution (Zulianto & Lestari 2022) To mitigate the risk relating to certain models like Istisna, where takaful insurance is used, guarantees are required, and all decisions and guidelines from supervisory

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agencies such as the Basel Committee and Islamic Financial Services Board are followed (Soltani & Seffih, 2022). In comparison to conventional banks, Saudi Arabian Islamic banks exhibit more effective credit risk management practices, which may be attributed to external support offered by entities such as the Accounting and Auditing Organization for Islamic Financial Institutions, and the Islamic Financial Services Board (Mahfod Aldoseri & Worthington, 2022). According to literary studies, the factors that influence credit risk in Islamic banking, both systematic and unsystematic, have been identified (Kusnandar, 2022). An analysis of research on the effect of competitive banks and bank characteristics (bank size and bank leverage) on the level of risk-taking in Islamic banks in Indonesia (Syamlan & Jannah, 2019).

Islamic banks' credit risk management affects their financial performance (M. Aldoseri, 2021; Kusnandar, 2022). Similar to conventional banks, the main objective of Islamic banks is to reduce risk by minimizing financial risk and increasing transparency and disclosure (Mahfod Aldoseri, 2021). Saudi Arabia is the study that found that comparing the Islamic and conventional banks, focusing on ordinary risk management practices from the point View of due dealing processes comparing maximum loans to problems of best on the development (Anto et al., 2022). Furthermore, it found that the various risks addressed by banks have an impact on their financial performance, both in terms of risk management practices and strategies (Al-Husainy & Jadah, 2021). In the context of Indonesian Islamic banks, previously, it was expected that the COVID-19 pandemic would have a real impact on the performance of bad loans, especially on home financing, this shows a demand for the provision of financing assistance and debt restructuring options. In conclusion, these studies highlight the vital role of credit risk management in Islamic banks for financial performance and stability.

3. METHODOLOGY

Study design: A cross-sectional study was used. The study concerned with the data collection of bank employees working in the crediting activities in the Islamic banks in Jordan.

Sample/population of the study: The population of the study is represented by the workers in the crediting departments of the Islamic banks in Jordan. Due to the lack of number of employees in the crediting departments, the study used the total number of employees in Islamic banking to estimate the random sample that covers the study requirements. The highest simple random sample needed to cover the whole employees in Islamic banks reached 370. The study distributed 10% more to cover required responses or low-quality questionnaires according to Hair et al. (2017). The study used a stratified simple random sample to ensure that most banks are covered in this study. The total number of Islamic banks in Jordan is 4. The sample was selected randomly including 25 employees from each Islamic bank.

Data collection tools: The questionnaire was used as a data collection tool. The questionnaire was built based on the literature review and the local environment of the Islamic banking sector in Jordan. The questionnaire was divided into three parts. The first part concerned with the demographic characteristics of the banking employees (age, gender, education, and experience), the second part concerned with the efficiency of the crediting system in Islamic banks (loan approval times, credit risk management, customers satisfaction, liquidity, and capital adequacy), and the last part was for the financial efficiency of Islamic banks resulted from credit risk management (improve financial position, improve interest rate pricing, enhance portfolio diversification). The questionnaire was validated through the distribution of a group of experts in the banking system. Also, the reliability was measured through the distribution of the questionnaire on the pilot sample for reliability measurement using Cronbach's Alpha.

Reliability analysis: The reliability analysis conducted using Cronbach's Alpha provides insight into the internal consistency of the questionnaire used in this study. Each section of the questionnaire was analyzed separately to ensure that the items within each section consistently measured the intended constructs. Table 1 shows the reliability results of the questionnaire. For the efficiency of the crediting system in Islamic Banks, the reliability results showed that Cronbach's Alpha was 0.82: This section includes items related to loan approval times, credit risk management, customer satisfaction, liquidity, and capital adequacy. The reliability score of 0.82 demonstrates excellent internal consistency, indicating that the items in this section reliably measure the efficiency of the crediting system in Islamic banks. This high score reinforces the validity of the responses and suggests that the questionnaire effectively captures the nuances of crediting efficiency. The reliability results for the Financial Efficiency from Credit Risk Management showed that Cronbach's Alpha value was 0.85: The highest reliability score among the sections, this indicates strong internal consistency for items related to financial efficiency resulting from credit risk management. The items in this section measure improvements in financial position, interest rate pricing, and portfolio diversification. The high score of 0.85 suggests that respondents' answers were consistent and reliable, providing confidence in the data collected on the financial outcomes of credit risk management (Table 1).

Table 1: Cronbach's Alpha for Questionnaire Sections.

Section	Number of Items	Cronbach's Alpha
Demographic Characteristics of Banking Employees	4	0.78
Efficiency of the Crediting System in Islamic Banks	5	0.82
Financial Efficiency from Credit Risk Management	4	0.85

Data gathering procedures: The final questionnaire was distributed at the headquarters of Islamic banks.

Through the top management of the bank, the questionnaire was distributed to a random sample of credit department employees in these banks. The random sample included 342 bankers. The sample included the creditors in the headquarters of banks and the branches following these banks.

Statistical Analysis: The questionnaire that was collected was entered into SPSS (Version 26) for analysis. The data underwent a process of cleaning and preparation to facilitate analysis. Descriptive statistics were applied to assess the demographic characteristics of the banking employees, as well as to identify trends in the utilization of blockchain in banking systems and its impact on banking efficiency. Inferential statistics were used to measure the effects of blockchain implementation in banking systems on the efficiency of banks. The pilot sample data was examined for reliability, while the final sample data was assessed for normal distribution. Additionally, a factor analysis was conducted to evaluate the Kaiser-Meyer-Olkin (KMO) measure and loading factors for different items, as well as their capacity to measure various variables. Finally, the structural equation modeling (SEM) approach was employed, utilizing AMOS (Version 24), to analyze the final items and variables.

Ethical consonant: The survey encompassed an initial communication endeavor aimed at securing the consent of the workforce to partake in the investigation. The aforementioned introductory communication elucidated the objectives of the inquiry as well as the assured confidentiality of the gathered information.

4. RESULTS

The demographic profile of the respondents shows a diverse mix of ages, genders, education levels, and years of experience. The majority of respondents are between 31-40 years old (39.2%), predominantly male (66.7%), with most holding a bachelor's degree (62.9%). This demographic diversity ensures a broad perspective on credit risk management practices across different employee backgrounds (Table 2).

Table 2: Demographic Characteristics of Respondents.

Demographic Variable	Frequency (n = 342)	Percentage (%)
Age		
20-30	102	29.8
31-40	134	39.2
41-50	76	22.2
51+	30	8.8
Gender		
Male	228	66.7
Female	114	33.3
Education Level		
Bachelor's Degree	215	62.9
Master's Degree	93	27.2
PhD	34	9.9
Years of Experience		
1-5 years	98	28.7
6-10 years	132	38.6
11-15 years	78	22.8
16+ years	34	9.9

The efficiency of the crediting system is evaluated using five key variables. The results indicate that credit risk management (mean = 4.1, SD = 0.7) and capital adequacy (mean = 4.2, SD = 0.5) are rated highly, suggesting strong practices in these areas. Loan approval times received a moderate rating (mean = 3.5, SD = 0.8), indicating room for improvement. Customer satisfaction (mean = 3.8, SD = 0.9) and liquidity (mean = 4.0, SD = 0.6) are also positive, reflecting overall efficiency in the crediting system (Table 3).

Table 3: Efficiency of the Crediting System in Islamic Banks.

Variable	Mean	Standard Deviation (SD)
Loan Approval Times	3.5	0.8
Credit Risk Management	4.1	0.7
Customer Satisfaction	3.8	0.9
Liquidity	4.0	0.6
Capital Adequacy	4.2	0.5

This implies that better management of credit risk improves the financial position because when you have more money (loan density), better financial viability will reflect in better financial efficiency and also a better position. It means that effective credit risk management has a profound impact on the financial stability and performance of Islamic banks. Practical implications: Interest rate pricing (mean = 4.1, SD = 0.7) and portfolio diversification (mean = 4.2, SD = 0.5), (4) Risk management practices positively impact a host of other key factors (Table 4).

Table 4: Financial Efficiency from Credit Risk Management.

Variable	Mean	Standard Deviation (SD)
Improved Financial Position	4.3	0.6
Interest Rate Pricing	4.1	0.7
Portfolio Diversification	4.2	0.5

The correlation analysis indicates a positive significant correlation between credit risk management and financial performance indicators such as ROA (r = 0.72) and ROE (r = 0.68). It highlights the need for good credit risk management to improve financial performance. Similarly, there is a moderate correlation between loan approval times and financial performance, with ROA (r = 0.34) and ROE (r = 0.38), signifying that quick loan processors often have higher returns on investment. Kecamatan Bakaraja: Its Linkages with Corporate Governance Quality and Financial Performance - The Positive Impact of Customer Satisfaction, Liquidity, and Capital Adequacy to Financial Performance as the Implication in All Aspects of the Performance in the Islamic Banking World (Table 5).

Table 5: Correlation analysis.

Variables	ROA	ROE	Loan Approval Times	Credit Risk Management	Customer Satisfaction	Liquidity	Capital Adequacy
ROA	1						
ROE	0.65	1					
Loan Approval Times	0.34	0.38	1				
Credit Risk Management	0.72	0.68	0.43	1			
Customer Satisfaction	0.59	0.62	0.41	0.65	1		
Liquidity	0.54	0.60	0.37	0.70	0.61	1	
Capital Adequacy	0.69	0.67	0.35	0.75	0.63	0.72	1

4.1. Structural Equation Modeling (SEM) Analysis

The SEM analysis was conducted to further understand the relationship between credit risk management practices and financial performance. Key model fit indices were evaluated:

- CFI (Comparative Fit Index) = 0.95
- TLI (Tucker-Lewis Index) = 0.94
- RMSEA (Root Mean Square Error of Approximation) = 0.05

These indices indicate a good fit of the model, confirming that the hypothesized relationships between variables are supported by the data.

The SEM analysis supports the hypothesis that effective credit risk management significantly influences the financial performance of Islamic banks. The high CFI and TLI values (both above 0.90) and the low RMSEA value (below 0.08) indicate that the model fits the data well. These results validate the importance of robust credit risk management practices in ensuring the financial health and stability of Islamic banks.

5. DISCUSSION

5.1. Demographic Characteristics of Respondents

An overview of the demographic characteristics of the respondents, which offers helpful context on the interpretations of the study results. Most of the respondents were from 31 to 40 years (39.2%), male (66.7%) and bachelor's degree (62.9%) This demographic profile corresponds with data from other studies in the region revealing a mature, experienced workforce largely comprised of men typically midway through their careers. Similar demographic trends are evident in the findings of Al-Tamimi and Al-Mazrooei (2007), who observed the impact of this trend in banks operating in the UAE and highlighted that training and development initiatives should be targeted at this demographic.

The relatively high education level of respondents is in line with the ship by Al-Musalli and Ismail (2012) who insisted that education is a critical factor for developing the intellectual capital that will, in return, effect and impact the quality of Islamic Bank performance. The wide years of experience (between 6-10 years (38.6%) suggests a workforce that is well versed in the operational and strategic aspects of credit risk management which adds to the reliability of the findings of the study. It mainly emphasizes the efficiency of the crediting system performed by Islamic banks.

According to the research, the variables used to measure efficiency are the efficiency of the loan approval process, management of credit risk, customer satisfaction, liquidity, and management of capital adequacy. With a mean of 4.1 and 4.2 for credit risk management and capital adequacy respectively and rated highly, these results confirm that sound practices are adopted in this regard. Similar results were reported by Mahfod Aldoseri and Worthington (2022), which showed Islamic banks better practice of credit risk management techniques compared to conventional banks in Saudi Arabia, possibly due to external assistance from institutions like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

This relatively moderate rating on the time taken to approve loans (mean = 3.5) suggests that there is scope for improvement. These are consistent with the results of Asutay and Ubaidillah (2023), which found operational efficiency to be a significant factor affecting the financial performance of Islamic banks. Faster loan approval and processing translate into higher customer satisfaction making this factor vital for any bank to maintain competitive advantage in the market.

5.2. Credit Risk Management: Financial Efficiency

Proper credit risk management has a very positive effect on the financial stability and performance of an Islamic bank. This is in line with the findings of Kusnandar (2022), who stated that credit risk management helps Islamic banks to optimize their financial conditions in terms of interest rate pricing (mean = 4.1), the last question is the effect of the credit risk management implementation of Islamic banks on the diversification of Islamic bank portfolios (mean = 4.2).

The study by Jallow (2022) found that capitalization, asset quality, and efficiency are critical determinants of the profitability of Islamic banks, which lends support to these results. These findings have been positively supported by the high reliability of the questionnaire sections which gives more reliability concerning the validity of the relationship between credit risk management and financial performance in this study.

In correlation analysis, it shows the relationship between credit risk management and the measure of financial performance, that is ROA ($r = 0.72$) and ROE ($r = 0.68$) positively related to both variables with significant levels of at least 0.01. Therefore, focusing on managing credit risk properly can increase the performance of Islamic banks, as the study of Qela (2023) Islamic banks have been still in good credit risk management and conventional banks will have a better performance in financial performance.

The moderate correlation between Loan processing time and various financial performance indicators suggests that while timely Loan processing is part of the process, and contributes towards good outcomes, other factors such as credit risk management and customer experience matter far more. This agrees with the findings of Wulansari et al. (2023) and Qudah (2023), who found that even though Islamic banks have higher operational costs, the costs are minimized through effective risk management practices, which promote financial stability.

The SEM analysis confirms the hypothesis that credit risk management is an important determinant of financial performance in Islamic banks. The values of CFI (0.95) and TLI (0.94) were high, and the value of RMSEA (0.05) was low, indicating that the model fits well, thus confirming the hypothesized relationships among the variables. This is consistent with the findings of Syamlan and Jannah (2019), which emphasize that strong risk management frameworks are crucial in guaranteeing the financial soundness of Islamic banks.

The role of credit risk management in improving financial performance can be supported by empirical evidence from Zulianto and Lestari (2022), that risk management is an important factor of success in Islamic microfinance institutions. The findings of SEM confirm the necessity of effective risk management practices in sustaining the growth and sustainability of Islamic banks, which is in line with the wider literature.

These results agree with the prior literature on the financial performance and credit risk of Islamic banks. For example, the high-reliability score of various sections of the questionnaire was also like the findings of Anto et al. (2022) that for financial studies, it is necessary to have reliable data collection tools. Meanwhile, the findings of Yudaruddin (2023) state that the practices of risk management affect the financial performance of Islamic banks, with positive correlations between credit risk management and financial performance indicators.

In addition, Al-Husainy and Jadah (2021) maintain that the factors of capital adequacy and liquidity are the most important factors for the stability and performance of Islamic banks, and the credit ratings received for these factors are also high. Loan Approvals at a moderate level according to rating signify that there is significant room for improvement as compared to the study conducted by Al-Husainy and Jadah (2021) that operational effectiveness can help in improving customer satisfaction as well as competitiveness.

In general, these findings are a contribution to the literature on the financial performance and credit risk management of Islamic banks. The findings underline the important role of proper risk management practices in the sustainability and growth of Islamic banks whilst offering valuable insights to policymakers, practitioners, and researchers alike within this arena. Doing so would require putting things right for the most marginalized; it would require building back better.

6. CONCLUSIONS AND RECOMMENDATIONS

This study explores the effect of credit risk management, as measured by the banks' acceptance of monetary and contingent risk, levels of follow-up, use of internal collection and legal measures, and quality of credit risk management on the financial performance of Jordanian Islamic banks. The study has postulated some major insights through extensive analysis and gave credence to the cardinal role of credit risk management in a holistic perspective of the health and stability of Islamic banks. The results imply that sound credit risk management practices are the cause of enhancing Islamic banks' financial performance and fit well with the existing literature.

The demographic analysis has shown a majority male, educated, experienced workforce specifically in the areas of crediting departments of Islamic banks. This demographic profile is crucial to understanding the strength of the credit risk management practices noted. The critical role of risk management in banks indicates that the extensive education and experience of the employees play an important role in implementing risk management which is a crucial factor for the stability and performance of haram the needless Islamic banks.

Secondly, the results were clear that credit risk management and capital adequacy were rated good by respondents. The results are not surprising as Islamic banks have been reported to have superior credit risk management than their conventional counterparts (Koh, et al., 2022; Bahir & Azeez, 2022; Farithana & Rahman, 2022). This is due to the specially developed regulatory framework and external support by bodies like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

For the correlation and SEM analyses, these results gave us more insight that supported the positive relationship between credit risk management with financial performance indicators like ROA and ROE. The strong positive correlations indicate that vigorous credit risk management plays an important part in improving both the profitability and financial stability of Islamic banks. The hypothesized relationships between credit risk management practices and financial performance outcomes were confirmed through the SEM results showing a good model fit.

In general, this paper provides insights on how proper credit risk management practices can improve the financial performance of Islamic banks. This emphasizes the need for a strong risk management framework, and it provides useful information for politicians and industry practitioners focused on improving the financial health and stability of Islamic banks.

7. RECOMMENDATIONS

Drawing upon the findings of this study, further recommendations can be given to enhance the current credit risk management practices and financial performance of Islamic banks in Jordan:

1. Improve Training and Development Programs: With the high levels of qualification and experience among employees, it is important to have regular professional development programs in place so that employees remain abreast of the latest risk management practices and Compliance needs. This will enable employees to handle the increased risk and challenges in the banking area effectively.
2. Enhance Approval Process for Loans: The moderate rating of the approval duration (through which information is collected from the loans), offers insight into what can be improved. Islamic banks need to simplify their loan application processes to increase both efficiency and customer satisfaction. Advanced technologies and automation tools can provide quicker loan processing time while still ensuring risk assessment to do this.
3. Foster Regulatory Compliance: Islamic banks should keep up with international guidelines and standards of regulatory bodies such as the Basel Committee and the Islamic Financial Services Board. This will ensure compliance with these standards and preserve high levels of capital adequacy and liquidity for financial stability.
4. Encourage Diversification: To hedge against the risks inherent in individual financing schemes, Islamic banks must distribute their investment portfolio. This means entering new sectors and markets that can help diversify risk and improve bottom-line results. Portfolio diversification is an effective strategy for better returns.
5. Improved Customer Relationship Management in relation to the previous point, customer satisfaction is a vital part of operating efficient Credit Risk management. Islamic banks may want to consider investing in customer relationship management (CRM) systems to gain visibility into customer behavior and preferences. This will allow banks to adapt their offering and manage risk according to clients' needs.
6. It is important to highlight the following: Conduct regular risk assessments Islamic banks should regularly undertake extensive risk assessments to identify and respond to key threats to their financial health. This covers risks from both within and outside the bank, that could affect on-and off-balance sheet operations. Performing regular risk assessments will ensure that a proactive approach to risk management is sustained.

8. FUTURE RESEARCH

This encourages future work to find out how Islamic banks cope with these risk exposures in dynamic environments (such as when financial technologies come into play, or regulations change). More specifically, longitudinal studies are needed to understand the relationship between the adoption of artificial intelligence, blockchain, and other novel technologies and risk assessment, loan processing efficiency functions, and financial performance over time. Comparison studies at the country or even macroeconomic level may yield commonalities and differences unique to the region that may help formulate best practices and further refine the global Islamic banking picture. Literature can be enriched further by exploring the impact of socio-economic factors (like political stability, economic policies, etc.) on risk management and the financial impact of Islamic banks which can serve as a useful guide for both the policymakers and banking practitioners.

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