



Financial Sustainability and Social Justice: A Regulatory Framework for Loan Control and Mitigation Of Default Risks in Jordanian Islamic BANKS

Sadam Mahmoud Ali Al Zuoby^{1*}, Muhammad Aunurrochim Mas'ad Saleh²
^{1,2}Universiti Sains Islam Malaysia

*Corresponding Author : zoubi_saddam@live.com

Abstract. *This study aims to achieve two primary objectives: first, to analyze loan default ratios at the Jordan Islamic Bank during 2023 and 2024 in order to identify recent trends in credit risk; and second, to examine the impact of applying a borrowing cap, whereby total debt obligations do not exceed 45% of a client's income, on reducing defaults and promoting social justice. The significance of the study lies in its attempt to bridge the gap between the financial sustainability of banks and the protection of society from excessive indebtedness, which reflects the essence of Islamic finance in balancing economic and social dimensions. The findings revealed that the ratio of non-performing loans at the Jordan Islamic Bank remained relatively low at approximately 2.2%, despite a slight increase in the absolute value of defaulted debts. The study recommends the implementation of a unified national system for financial obligations that encompasses banks and other institutions, the enforcement of borrowing cap policies (45% of income), enhanced financial literacy among clients, and the development of advanced data analytics tools to proactively monitor risks. These measures would not only strengthen the financial sustainability of the Jordan Islamic Bank but also contribute to the promotion of social justice.*

Keywords: Borrowing cap; Credit risk; Financial sustainability; Islamic Bank; Jordan Islamic finance; non-performing loans.

1. Introduction

Islamic banks constitute a fundamental pillar of the modern financial system, striving to achieve a balance between the demands of economic growth on one hand and the principles of social justice on the other. Unlike conventional banks, which operate on interest (riba), Islamic banks rely on financing structures based on risk-sharing, profit distribution, and participatory investment models. As their role in the Jordanian economy has expanded, so have the challenges associated with managing and regulating loans in a manner that ensures the sustainability of banking operations while safeguarding clients' livelihood rights.

One of the most prominent challenges is client default, which adversely affects both the stability of banks and public confidence in the banking sector. In the context of Jordan's current economic conditions, particularly with rising inflation rates and fluctuating income levels, a key question arises regarding the capacity of Islamic banks to establish regulatory frameworks that limit excessive borrowing and prevent individuals from incurring financial burdens beyond their means.

This study aims to analyze the relationship between financial sustainability and social justice in light of the experience of Jordanian Islamic banks. It explores the feasibility of creating a participatory regulatory system involving banks and institutions that balances

the interests of all stakeholders. Additionally, it seeks to provide a practical framework to enhance Islamic financing instruments in alignment with Sharia objectives, while maintaining an equilibrium between profitability considerations and social dimensions.

Problem Statement

The study's central problem lies in the challenges faced by Jordanian Islamic banks due to high rates of loan defaults, reflecting the absence of effective regulatory mechanisms to set borrowing limits in accordance with clients' financial capacities while preserving their livelihood rights. Expanding financing without precise control over income levels results in individuals undertaking financial obligations beyond their means, thereby impeding their ability to meet these commitments and imposing severe living burdens. Concurrently, banks incur increasing financial losses, reduced liquidity, and lower profitability, which threatens their long-term financial sustainability. Consequently, there is a clear need for a regulatory framework that balances the social justice requirements of individuals with the financial sustainability imperatives of banks.

Reducing Default Risks in Jordanian Islamic Banks

In financial sciences, risks are defined as the likelihood of losses or unexpected outcomes that affect the expected returns of financial institutions. Risk management is a fundamental component of bank sustainability, as it helps minimize losses and safeguard financial stability (Jorion, 2007). Credit default risk, specifically, arises when a borrower fails to meet their financial obligations according to the agreed terms, whether due to complete inability to pay or partial delays. These risks are considered among the most critical facing banks, as they directly impact asset quality, liquidity, and profitability (Greuning & Bratanovic, 2020).

The primary causes of loan defaults can be classified into internal factors related to the client and external factors linked to the economic environment. At the individual level, defaults may result from reduced income, job loss, or poor personal financial management. At the macroeconomic level, economic recession, inflation, and rising unemployment rates are among the key factors that increase the likelihood of default (Louzis, Vouldis, & Metaxas, 2012)

2. Methods

This study employed an analytical of financial data from Jordanian Islamic banks (2020–2024) with qualitative insights which focusing on indicators such as non performing loans, provisions and measures adopted to address default risks. Gathering data, including annual reports and Central Bank statistics, are examined to track non-performing loans, liquidity, and profitability, while regression and scenario testing assess the impact of loan-to-income ratio controls on default risks.

3. Results and Discussion

3.1. Primary Causes of Loan Default Risks

Results should be clear and concise. Show only the most significant or main findings of the research. Discussion must explore the significance of the results of the work. Adequate discussion or comparison of the current results to the previous similar published articles should be provided to shows the positioning of the present research (if available).

3.1.1. Client-Related Factors (Individual Level):

- a) Low monthly income or loss of livelihood.
- b) Poor personal financial management and lack of financial planning.
- c) Accumulation of debts due to excessive borrowing.
- d) Limited financial literacy and lack of awareness of obligations.
- e) Sudden life changes, such as illness, death, or divorce (Louzis, Vouldis, & Metaxas, 2012).

3.1.2. Economic Environment Factors (Macro Level):

- a) Economic recession, which reduces employment opportunities and repayment capacity.
- b) Inflation and rising living costs, which diminish individuals' purchasing power.
- c) High unemployment rates and limited job opportunities.
- d) General economic crises, such as pandemics or political instability (Greuning & Bratanovic, 2020).

3.1.3. Bank and Financial Institution Factors:

- a) Granting loans exceeding the client's repayment capacity without thorough assessment.
- b) Weak credit evaluation systems and inadequate financial analysis of clients.
- c) Absence or weakness of internal control mechanisms to monitor obligations.
- d) Over-reliance on insufficient or non-collectible guarantees.
- e) Banks' competitive drive to expand lending without considering portfolio quality (Chapra & Khan, 2000; Jorion, 2007).

3.2. Enhancing Social Justice and Protecting Clients' Livelihood Rights

Social justice in Islamic finance is a core principle that distinguishes it from conventional financial systems. It aims to balance the interests of financial institutions with individual rights, ensuring a fair and sustainable distribution of economic resources. Islamic finance emphasizes Sharia principles, which prohibit interest (riba), encourage risk-sharing, and promote transparency in financial transactions, thereby reinforcing justice and equity among all stakeholders (Usmani, 2018).

One of the key mechanisms to achieve social justice in Islamic banks is setting a borrowing cap aligned with the individual's income, ensuring that financial obligations remain within repayment capacity without compromising the client's livelihood. Islamic finance also utilizes instruments such as Murabaha, Musharaka, and Mudaraba, which allow risk-sharing and equitable participation in profits and losses, further protecting the rights of all parties (El-Gamal, 2006).

Furthermore, Islamic finance emphasizes transparency and social responsibility, requiring banks to fully disclose loan terms and obligations. This reduces financial exploitation and strengthens mutual trust. Research indicates that adherence to these principles contributes to financial and social stability and reduces default rates, thereby protecting clients' rights and ensuring their ability to meet essential needs (Sundararajan & Errico, 2002).

3.3. The Relationship Between Default Reduction and Social Justice

Reducing loan defaults is a fundamental element in achieving social justice within the Islamic financial system. High default ratios increase financial burdens on banks, potentially

undermining their ability to provide sustainable financing to individuals and businesses. Effective default management not only safeguards bank stability but also enhances the equitable distribution of financial resources across society (Aledeimat, 2025).

Literature indicates that financial policies limiting defaults, such as capping loans at a certain percentage of monthly income, protect clients' livelihood by ensuring they do not assume obligations beyond their means. This promotes social justice by enabling low-income individuals to access finance without risking insolvency or deprivation of essential needs (Alandejani & Asutay, 2017).

Moreover, limiting defaults enhances transparency and accountability in the Islamic banking system, as it encourages banks to rigorously assess risk before granting financing and to monitor clients' repayment capacity. This approach contributes to a more stable and just financial environment, ensuring optimal allocation of economic resources and reducing the likelihood of clients falling into financial distress due to accumulated debt (Butt, 2025).

Tabel 1. Financial Ratios of the Jordan Islamic Bank

Item	2023	2024
Total Facilities / Loans	4,492,182,215	4,675,291,424
Total Exposure / Non-Performing Loans (NPL)	97,967,198	102,813,861
NPL Ratio = $(\text{Total Exposure} \div \text{Total Loans}) \times 100$	2.18%	2.20%

Note: The figures above are extracted from the "Default Distribution" tables and the summary of facilities in the annual reports of the Jordan Islamic Bank.

Documented Policies and Procedures (Extracted from Notes):

Classification and Provisioning Policies According to Central Bank Instructions

The reports indicate that the bank adheres to credit facility classification guidelines (categories: low-risk, acceptable-risk, under-monitoring, etc.) and applies corresponding provision rates (e.g., 1.5% to 15% for specific categories), in line with Central Bank instructions.

Detailed Credit Loss Provisions and Movements

The report includes a schedule of credit loss provisions (opening balance, additions/recoveries, write-offs, and closing balance) for different loan categories (performing loans, rescheduled/restructured receivables, etc.). Individual figures are documented in the notes on provisions.

Credit Portfolio Composition by Risk Grade

Reports show the distribution of facilities across credit grades (e.g., A, B+, CCC+, etc.) and indicate the share of each category along with its respective provision, enabling monitoring of risk concentration in specific sectors or segments.

Interpretative Summary (What the Figures Mean):

- a. The bank's NPL ratio remained low (approximately 2.18–2.20%) between 2023 and 2024; however, there was a slight increase in total exposure (from ≈98 million JOD to ≈103 million JOD). This marginal rise may reflect the growth in total facilities

(denominator increased to 4.675 billion JOD), the reclassification of certain loans into higher-risk categories, or changes in accounting treatment/classifications.

- b. The bank follows clear classification and provisioning rules as per Central Bank regulations, documenting measures such as rescheduling, provisioning, and write-offs. These practices support liquidity sustainability if implemented rigorously.

4. Conclusions

Relative Stability in Default Ratios: Financial statements indicated that the non-performing loan (NPL) ratio ranged between 2.18% and 2.20%, which is relatively low compared to the average of some banks in the region. This reflects the presence of effective risk management policies. However, the increase in the absolute value of non-performing loans (from 98 million JOD to 103 million JOD) suggests ongoing pressure on clients.

Primary Causes of Default: Most default cases stem from the limited repayment capacity of individuals and small enterprises, due to multiple loans from different financial institutions and declining cash flows. Additionally, external obligations, such as post-dated checks issued by institutions or companies outside the banking system, exacerbate the overall indebtedness.

Recommendations

1. **Develop a Unified National Database of Financial Obligations:** Establish a centralized system encompassing not only bank loans but also post-dated checks and facilities from non-banking institutions, enabling banks to assess clients' actual credit positions.
2. **Implement a Borrowing Cap:** Require banks to limit total obligations to no more than 45% of the client's income (including bank loans, checks, and other commitments), ensuring that at least 55% of income remains available for living expenses.
3. **Enhance Financial Literacy:** Launch awareness programs to educate clients about the risks of excessive borrowing and reliance on post-dated checks, while providing alternative Islamic financing solutions such as micro-Murabaha or small-scale financing with carefully assessed guarantees.
4. **Strengthen Oversight of Non-Banking Institutions:** Require companies that rely on post-dated checks to register their data in a unified credit system under Central Bank supervision, reducing overlaps that may lead to unexpected defaults.
5. **Enhance Transparency and Internal Bank Controls:** Develop advanced data analytics tools to identify highly indebted clients early and implement proactive intervention policies (e.g., rescheduling before complete default occurs)

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