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Liquidity Management Challenges in Islamic Banking: A Study of Short-Term Instruments

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Abstract

Liquidity management remains one of the most significant challenges in Islamic banking due to the prohibition of interest-based instruments and the limited availability of Shariah-compliant liquidity solutions. This study examines the structural and regulatory challenges affecting liquidity management in Islamic banks and evaluates the effectiveness of existing short-term Shariah-compliant instruments. Using a qualitative approach, the research employs doctrinal and comparative analysis of academic literature, regulatory frameworks, and institutional reports related to Islamic finance and liquidity risk management. The findings reveal that Islamic banks face persistent liquidity constraints caused by the scarcity of Shariah-compliant instruments, underdeveloped Islamic money markets, fragmented Shariah interpretations, and regulatory pressures associated with Basel III requirements. While instruments such as short-term sukuk, commodity murabaha (tawarruq), wakalah arrangements, and central bank facilities provide practical liquidity solutions, their effectiveness remains limited by insufficient market depth, scalability, and standardization. The study concludes that improving liquidity management in Islamic banking requires stronger regulatory coordination, harmonization of Shariah standards, expansion of Shariah-compliant high-quality liquid assets, and continuous financial innovation. Furthermore, emerging technologies such as fintech, blockchain, and tokenized sukuk offer promising opportunities to enhance liquidity efficiency while preserving Shariah compliance. These developments are essential for strengthening the resilience and competitiveness of the global Islamic banking industry.

Keywords

Islamic banking; liquidity management; Shariah-compliant instruments; sukuk, commodity murabaha; Basel III.

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Introduction

The Islamic banking industry has emerged as one of the fastest-growing segments of the global financial system, demonstrating remarkable resilience and sustained expansion over the past two decades. Driven by increasing demand for ethical and Shariah-compliant financial services, Islamic banking has evolved from a niche alternative into a significant component of international finance. Unlike conventional banking systems, Islamic banking operates under a unique set of principles derived from Islamic law, which prohibit riba (interest), gharar (excessive uncertainty), and maysir (speculation), while emphasizing risk-sharing, asset-backed financing, and socially responsible investment (Dusuki 2008). These foundational principles not only distinguish Islamic banking from conventional financial institutions but also position it as a financial system that seeks to integrate economic efficiency with ethical considerations (Abd Hakim et al. 2022).

The rapid growth of Islamic banking has generated increasing attention from policymakers, regulators, and academics. According to the Islamic Financial Services Board (IFSB), Islamic banking continues to account for the largest share of global Islamic finance assets, reflecting its growing significance within both Muslim-majority and non-Muslim jurisdictions (Abdullah and binti Pg 2025). Nevertheless, despite its impressive expansion, the industry continues to face several structural challenges that hinder its operational efficiency and long-term competitiveness. Among these challenges, liquidity management remains one of the most critical and persistent issues confronting Islamic financial institutions.

Liquidity management is a fundamental function of banking institutions because it ensures the availability of sufficient funds to meet short-term obligations while maintaining profitability and financial stability. Effective liquidity management enables banks to accommodate customer withdrawals, settle financial transactions, fulfill regulatory requirements, and respond to unexpected market shocks without incurring significant losses (Campello et al. 2011). In conventional banking systems, liquidity is supported by highly developed money markets and a wide range of short-term instruments, including treasury bills, repurchase agreements (repos), commercial papers, and interbank lending facilities. These instruments provide banks with flexible and efficient mechanisms to manage liquidity positions and respond quickly to changing market conditions (Bianchi and Bigio 2022).

In contrast, Islamic banks operate under significant constraints because many conventional liquidity instruments are based on interest-bearing transactions that are prohibited under Shariah principles (Mustaffha 2025). Consequently, Islamic financial institutions cannot fully utilize traditional money market instruments and must instead rely on alternative mechanisms designed to comply with Islamic legal requirements (Cahyati et al. 2025). This limitation creates a structural challenge in which Islamic banks are required to maintain adequate liquidity while simultaneously adhering to religious principles that restrict access to conventional liquidity sources (Ahmed et al. 2019).

Over the years, several Shariah-compliant liquidity instruments have been developed to address this challenge. These include short-term sukuk, commodity murabaha (tawarruq), wakalah arrangements, mudarabah contracts, and various central bank liquidity facilities specifically designed for Islamic financial institutions. While these instruments have contributed significantly to the development of Islamic liquidity management frameworks, their effectiveness remains a subject of ongoing debate (Agustina and Aini 2025). Many of these instruments face limitations related to market depth, standardization, tradability, transaction costs, and regulatory recognition. As a result, Islamic banks often encounter difficulties in achieving the same level of liquidity efficiency enjoyed by their conventional counterparts (Y.-J. Wang 2002).

The challenge of liquidity management has become increasingly important in the aftermath of the global financial crisis and the introduction of Basel III liquidity standards. The Basel III framework introduced more stringent requirements through the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), requiring banks to maintain sufficient high-quality liquid assets (HQLA) to withstand periods of financial stress (Q. Wang et al. 2026). Although these regulations were designed to strengthen financial stability, their implementation has presented unique challenges for Islamic banks. The limited availability of Shariah-compliant HQLA creates significant obstacles for Islamic financial institutions seeking to comply with international regulatory standards. Consequently, many Islamic banks are compelled to maintain larger liquidity buffers, potentially reducing profitability and limiting their ability to deploy capital efficiently (Fitriyah and Wardana 2023).

The literature on Islamic liquidity management has expanded considerably in recent years. Existing studies have examined the characteristics of sukuk markets, the operational mechanisms of commodity murabaha, the role of Islamic interbank money markets, and the impact of regulatory frameworks on liquidity risk management (J. Lewis et al. 2021). Other scholars have explored the relationship between liquidity risk and financial stability, arguing that the structural characteristics of Islamic banking may simultaneously enhance resilience while creating unique vulnerabilities during periods of market stress (Silvia et al. 2026). These studies have made important contributions to the understanding of Islamic banking operations and liquidity risk management practices.

However, despite the growing body of research, several important gaps remain in the literature. First, much of the existing research focuses on individual liquidity instruments rather than examining liquidity management as a comprehensive ecosystem involving instruments, regulatory frameworks, market infrastructure, and institutional arrangements. This fragmented perspective limits the ability to understand how different components of the Islamic financial system interact to influence liquidity outcomes. Second, many studies emphasize conceptual and Shariah-related discussions while providing limited evaluation of the practical effectiveness of liquidity instruments under actual market conditions. Third, comparative analyses assessing the efficiency of Islamic liquidity management frameworks relative to conventional systems remain relatively limited, particularly in relation to regulatory adaptation, market responsiveness, and operational performance.

Furthermore, the ongoing transformation of the global financial sector through digitalization, fintech innovation, blockchain technology, and tokenized financial assets introduces new opportunities and challenges for liquidity management. While these developments have begun reshaping conventional financial markets, their implications for Islamic liquidity management remain insufficiently explored. The emergence of digital financial infrastructures raises important questions regarding how Islamic banks can leverage technological innovation to overcome structural liquidity constraints while preserving Shariah compliance (Zetzsche and Anker-Sørensen 2022).

Against this background, this study argues that liquidity management challenges in Islamic banking should not be viewed solely as an issue of instrument availability. Rather, they represent a broader systemic challenge involving interactions among financial instruments, regulatory frameworks, institutional structures, market development, and Shariah governance mechanisms. The effectiveness of Islamic liquidity management depends not only on the existence of Shariah-compliant instruments but also on the broader ecosystem that supports their issuance, trading, regulation, and utilization.

Accordingly, this study aims to examine the challenges of liquidity management in Islamic banking with particular emphasis on short-term Shariah-compliant instruments. The study investigates the structural limitations affecting the availability and effectiveness of these instruments, evaluates their role in supporting liquidity management, and explores the institutional and regulatory factors that influence their performance. By adopting a comprehensive analytical perspective, this research seeks to contribute to the growing literature on Islamic finance by providing a deeper understanding of the complex relationship between liquidity management, regulatory compliance, and financial stability.

The study contributes to the literature in three important ways. First, it provides an integrated analysis of liquidity management challenges by combining theoretical, regulatory, and institutional perspectives. Second, it critically evaluates the effectiveness of existing short-term Islamic liquidity instruments in addressing contemporary banking needs. Third, it proposes a broader understanding of liquidity management as a systemic ecosystem involving instruments, institutions, market infrastructure, and regulatory coordination. Ultimately, enhancing liquidity management frameworks is essential for strengthening the resilience, competitiveness, and sustainability of Islamic banking in an increasingly complex and interconnected global financial environment.

Method

This study employs a qualitative research approach to examine liquidity management challenges in Islamic banking, with particular emphasis on the effectiveness of short-term Shariah-compliant liquidity instruments. A qualitative approach is considered appropriate because liquidity management in Islamic finance is not merely a technical financial issue but also involves complex interactions among regulatory frameworks, institutional arrangements, market infrastructure, and Shariah governance principles. Unlike quantitative approaches that focus primarily on numerical measurements and statistical relationships, qualitative research allows for a deeper exploration of conceptual, regulatory, and institutional dimensions that shape liquidity management practices within Islamic banking systems (Creswell and Creswell 2017). The study adopts a doctrinal and comparative perspective to analyze how Islamic banks manage liquidity under the constraints imposed by Shariah principles and international regulatory requirements.

The research relies exclusively on secondary data obtained from scholarly, regulatory, and institutional sources. Academic literature serves as the primary source of theoretical and conceptual insights regarding liquidity risk, Islamic financial instruments, and banking regulation. Peer-reviewed journal articles, books, conference proceedings, and research reports were reviewed to identify major debates and developments in the field of Islamic liquidity management. To ensure the relevance and quality of the literature, particular attention was given to publications indexed in reputable academic databases and published within the last decade.

Foundational studies that have significantly contributed to the development of Islamic finance theory were also included to provide historical and conceptual context. In addition to academic literature, regulatory documents issued by international organizations such as the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the Basel Committee on Banking Supervision (BCBS) were examined to understand the regulatory environment governing liquidity management practices in Islamic banking (Ahmed et al. 2019; Bassens et al. 2011).

The analysis was conducted using thematic analysis, a widely recognized qualitative method for identifying, organizing, and interpreting recurring patterns within textual data. Thematic analysis enables the systematic examination of literature and regulatory documents to uncover key issues affecting liquidity management in Islamic banking (Braun et al. 2023). The analytical process began with an extensive review of the selected literature and regulatory materials to identify concepts related to liquidity risk, liquidity instruments, market development, regulatory constraints, and institutional coordination. Relevant information was subsequently coded and grouped into broader thematic categories. Through this process, several dominant themes emerged, including the scarcity of Shariah-compliant liquidity instruments, the limited depth of Islamic money markets, regulatory challenges associated with Basel III implementation, the impact of divergent Shariah interpretations, and the role of institutional infrastructure in supporting liquidity management. These themes were then analyzed comparatively to evaluate similarities and differences between Islamic and conventional liquidity management frameworks and to assess variations across different Islamic banking jurisdictions.

To strengthen the practical relevance of the study, Malaysia was selected as an illustrative case due to its internationally recognized leadership in Islamic finance development. Malaysia possesses one of the most sophisticated Islamic financial ecosystems in the world, supported by a comprehensive regulatory framework, an active Islamic Interbank Money Market (IIMM), and regular issuance of Shariah-compliant liquidity instruments. The Malaysian experience provides valuable insights into how regulatory innovation, institutional coordination, and market development can contribute to more effective liquidity management practices. Reports and policy documents issued by Bank Negara Malaysia were therefore incorporated into the analysis to complement the broader theoretical and regulatory discussion (Shara et al. 2024).

The credibility and reliability of the findings were enhanced through data triangulation. Information derived from academic literature was cross-examined with regulatory reports, industry publications, and institutional documents to ensure consistency and reduce potential bias. The integration of multiple data sources enabled the study to capture diverse perspectives and provide a comprehensive understanding of liquidity management challenges within Islamic banking. Nevertheless, several limitations should be acknowledged. Since the study relies solely on secondary data, it does not incorporate primary evidence obtained through interviews, surveys, or direct observation. Furthermore, the qualitative nature of the research does not permit statistical testing or empirical measurement of causal relationships. Despite these limitations, the chosen methodological approach remains appropriate for achieving the study's objectives by providing an in-depth analysis of the structural, regulatory, and institutional factors influencing the effectiveness of short-term liquidity management instruments in contemporary Islamic banking systems.

Results and Discussion

Structural Constraints and Regulatory Challenges in Islamic Liquidity Management

Liquidity management remains one of the most persistent challenges confronting the Islamic banking industry despite its remarkable growth over the last two decades. While Islamic financial institutions have successfully established themselves as viable alternatives to conventional banks, their ability to manage short-term liquidity efficiently continues to be constrained by structural, regulatory, and institutional factors. Unlike conventional banking systems that benefit from highly developed money markets and a broad range of interest-based liquidity instruments, Islamic banks operate within a framework governed by Shariah principles that prohibit riba (interest), gharar (excessive uncertainty), and maysir (speculation) (Maulidar and Majid 2020). Although these principles provide the ethical foundation of Islamic finance, they simultaneously create limitations in the availability and flexibility of liquidity management tools (Iqbal et al. 2025; Aisyah et al. 2025).

The findings of this study indicate that liquidity management challenges in Islamic banking are not merely operational problems but represent deeper structural constraints embedded within the architecture of Islamic financial systems. One of the most significant challenges is the limited availability of Shariah-compliant short-term liquidity instruments. Conventional banks can easily access treasury bills, repurchase agreements (repos), commercial papers, and interbank lending facilities to manage liquidity fluctuations. In contrast, Islamic banks must rely on instruments such as sukuk, commodity murabaha (tawarruq), wakalah arrangements, and mudarabah contracts, which often lack the liquidity, scalability, and market depth necessary for effective short-term liquidity management (Setiawan et al. 2024).

The scarcity of liquid instruments creates a persistent mismatch between liquidity demand and liquidity supply. Islamic banks are required to maintain sufficient liquidity to meet depositor withdrawals, financing commitments, and regulatory requirements, yet the limited availability of suitable instruments restricts their ability to adjust liquidity positions rapidly. Consequently, many Islamic banks maintain excessive liquidity reserves as a precautionary measure. While this strategy enhances financial stability, it simultaneously reduces profitability because idle funds cannot be deployed effectively into productive investments (Saifurrahman and Kassim 2022).

Another critical challenge identified in the literature concerns the underdevelopment of Islamic money markets. Market infrastructure plays a central role in facilitating liquidity transfers among financial institutions. In conventional systems, active interbank markets enable banks to borrow and lend funds efficiently according to short-term liquidity needs (Musadad et al. 2026). However, Islamic interbank markets remain relatively shallow in many jurisdictions, limiting opportunities for liquidity redistribution. The absence of deep secondary markets further exacerbates the problem because financial institutions often hold Shariah-compliant securities until maturity rather than actively trading them. This practice reduces market turnover, weakens price discovery mechanisms, and diminishes the overall liquidity of Islamic financial instruments (Bianchi and Bigio 2022).

The implementation of Basel III liquidity standards has further intensified these challenges. Following the global financial crisis, Basel III introduced the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) to strengthen banking resilience and reduce systemic risk (BCBS, 2013). These regulations require banks to maintain adequate High-Quality Liquid Assets (HQLA) capable of absorbing liquidity shocks during periods of market stress. However, the availability of Shariah-compliant HQLA remains limited, placing Islamic banks at a disadvantage relative to conventional institutions. While government-issued sukuk may qualify as HQLA under certain circumstances, the overall supply remains insufficient to satisfy industry-wide demand. As a result, Islamic banks frequently face difficulties in achieving regulatory compliance without compromising profitability and operational efficiency (IFSB, 2020).

A further structural challenge arises from the lack of harmonization in Shariah interpretation across jurisdictions. Although Islamic finance is built upon common principles derived from Islamic law, significant differences exist regarding the permissibility and structure of financial instruments. Commodity murabaha transactions, for example, are widely accepted in some jurisdictions but remain controversial in others. Similar differences exist regarding various sukuk structures and liquidity arrangements. This fragmentation reduces standardization, limits cross-border liquidity flows, and creates legal uncertainty for financial institutions operating in multiple jurisdictions (Islam et al. 2023). Consequently, the development of integrated global Islamic money markets remains constrained by divergent regulatory and Shariah governance frameworks.

The findings also reveal that operational complexity contributes significantly to liquidity management inefficiencies. Many Shariah-compliant transactions involve multiple contractual stages and require coordination among several parties. Compared with conventional instruments that can be executed almost instantaneously, Islamic liquidity arrangements often require additional documentation, asset transfers, and compliance verification processes. These procedural requirements increase transaction costs and reduce the responsiveness of Islamic banks to rapidly changing liquidity conditions (Kamla and Haque 2019). Such operational frictions become particularly problematic during periods of financial stress when immediate access to liquidity is essential.

The cumulative impact of these structural and regulatory challenges extends beyond individual institutions and affects the broader stability of Islamic financial systems. Limited liquidity flexibility can constrain financing activities, reduce profitability, and weaken competitiveness relative to conventional banks. Moreover, underdeveloped liquidity markets hinder the transmission of monetary policy and reduce the effectiveness of central bank interventions within Islamic financial systems. Consequently, the sustainability and future growth of Islamic banking depend not only on the development of new liquidity instruments but also on broader reforms aimed at strengthening market infrastructure, enhancing regulatory coordination, and promoting greater standardization across jurisdictions.

Table 1 Major Structural and Regulatory Challenges in Islamic Liquidity Management

Challenge	***Description***	***Impact on Islamic Banks***
Limited Availability of Instruments	Scarcity of Shariah-compliant short-term liquidity tools	Reduced liquidity flexibility
Underdeveloped Money Markets	Weak interbank and secondary markets	Difficulty transferring liquidity

Basel III Compliance	Limited access to Shariah-compliant HQLA	Regulatory pressure and higher liquidity costs
Shariah Fragmentation	Different interpretations across jurisdictions	Reduced standardization and cross-border integration
Operational Complexity	Multi-stage contractual structures	Higher transaction costs and slower execution
Limited Market Depth	Low trading volume of Islamic securities	Increased market liquidity risk
Institutional Constraints	Lack of developed Islamic liquidity infrastructure	Reduced financial efficiency

The findings suggest that the challenges facing Islamic liquidity management should be understood as systemic rather than isolated issues. Addressing these constraints requires coordinated efforts among regulators, standard-setting bodies, central banks, and financial institutions to develop a more integrated and resilient liquidity ecosystem capable of supporting the continued expansion of Islamic banking in the global financial system.

Effectiveness of Shariah-Compliant Short-Term Instruments and Future Directions

The development of Shariah-compliant short-term liquidity instruments represents one of the most significant achievements in the evolution of Islamic finance. Since Islamic banking institutions are prohibited from utilizing conventional interest-based liquidity facilities, the industry has continuously sought alternative mechanisms capable of fulfilling liquidity management functions while remaining consistent with Shariah principles. Over the past two decades, various instruments such as short-term sukuk, commodity murabaha (tawarruq), wakalah arrangements, mudarabah contracts, and central bank liquidity facilities have emerged as practical solutions to address liquidity needs (Hassan et al. 2024). Despite these advancements, the effectiveness of these instruments remains a subject of ongoing debate among scholars, regulators, and practitioners. The findings of this study indicate that while existing instruments have contributed significantly to the operational sustainability of Islamic banking, they continue to face substantial limitations related to market efficiency, scalability, regulatory recognition, and institutional integration (Mohd Zain et al. 2024).

Among the available liquidity instruments, short-term sukuk have become one of the most important mechanisms for liquidity management within Islamic financial systems. Sukuk are generally regarded as Shariah-compliant alternatives to conventional bonds because they represent ownership interests in underlying assets rather than debt obligations. Their asset-backed nature makes them compatible with Islamic legal principles and allows them to function as tradable financial instruments. In many jurisdictions, government-issued short-term sukuk have become valuable tools for liquidity management because they provide relatively secure and liquid investment opportunities for Islamic banks while supporting compliance with regulatory liquidity requirements (Özdemïr et al. 2023). Furthermore, certain sukuk structures qualify as High-Quality Liquid Assets (HQLA), enabling Islamic financial institutions to satisfy Basel III requirements more effectively (Ihrig et al. 2019).

Nevertheless, the practical effectiveness of sukuk remains constrained by several factors. The supply of short-term sukuk remains insufficient in many jurisdictions, resulting in persistent demand-supply imbalances. In addition, secondary markets for sukuk are often characterized by limited trading activity, reducing their usefulness as actively tradable liquidity instruments. Many investors prefer to hold sukuk until maturity, which decreases market turnover and weakens price discovery mechanisms. Consequently, although sukuk provide an important source of liquidity, they have not yet achieved the same level of market efficiency as conventional government securities (Wilson and Gilbert 2008). This limitation highlights the need for broader market participation, improved trading infrastructure, and greater issuance frequency to enhance their effectiveness as liquidity management tools.

Commodity murabaha, commonly referred to as tawarruq, has emerged as another widely utilized instrument for short-term liquidity management. Unlike sukuk, tawarruq is frequently employed because of its flexibility and ability to generate immediate liquidity (Ayub 2020). Through a sequence of commodity transactions involving multiple parties, Islamic financial institutions can obtain short-term funding without directly engaging in interest-based borrowing. The widespread adoption of tawarruq demonstrates its practical utility in contemporary Islamic banking operations (M. K. Lewis and Algaoud 2001). Many Islamic interbank transactions and central bank liquidity facilities are structured around commodity murabaha due to its operational adaptability and relatively rapid execution.

However, the extensive reliance on tawarruq has generated significant academic and Shariah-related concerns. Critics argue that while tawarruq satisfies formal legal requirements, its economic substance closely resembles conventional lending arrangements. As a result, questions have emerged regarding its consistency with the broader objectives (maqasid) of Islamic finance, which emphasize genuine risk-sharing and real economic activity (El-Gamal 2006). Moreover, tawarruq transactions often involve multiple contractual stages, increasing administrative complexity and transaction costs. These concerns suggest that although commodity murabaha serves as an effective short-term liquidity instrument, its long-term sustainability as the dominant liquidity management mechanism remains uncertain.

Wakalah-based arrangements represent another important category of Shariah-compliant liquidity instruments. Under wakalah contracts, one institution appoints another as an agent to manage funds in accordance with predetermined investment guidelines. These arrangements provide Islamic banks with a relatively flexible mechanism for placing surplus funds or obtaining short-term financing (Paizin and Sarif 2021). Wakalah instruments are generally considered more closely aligned with the risk-sharing philosophy of Islamic finance compared to tawarruq-based structures because they involve genuine investment activities rather than synthetic liquidity generation (Karim et al. 2020). Nevertheless, their effectiveness remains constrained by agency risks, uncertainty regarding investment returns, and the absence of guaranteed outcomes. Such characteristics can reduce their attractiveness for institutions seeking predictable liquidity management solutions.

Similarly, mudarabah-based instruments embody the foundational principles of Islamic finance through profit-and-loss sharing arrangements. In theory, mudarabah contracts offer an ideal framework for Islamic financial intermediation because they promote equitable risk distribution between capital providers and entrepreneurs. However, their practical application in liquidity management remains limited. Banks generally require liquidity instruments capable of providing predictable cash flows and immediate liquidity access, whereas mudarabah structures involve uncertainties related to profit generation and investment performance (Susanto et al. 2025). Consequently, despite their strong theoretical alignment with Islamic finance principles, mudarabah instruments have not become major components of contemporary liquidity management frameworks.

The findings further demonstrate the crucial role of central banks in supporting the effectiveness of Islamic liquidity management systems. In jurisdictions where Islamic banking has achieved significant market presence, central banks have developed specialized liquidity facilities designed to address the unique needs of Islamic financial institutions (Svartzman et al. 2021). Malaysia provides one of the most prominent examples of successful institutional innovation in this regard. Through the establishment of the Islamic Interbank Money Market (IIMM), regular issuance of short-term sukuk, and Shariah-compliant standing facilities, Bank Negara Malaysia has created an integrated liquidity management ecosystem that supports both regulatory compliance and operational efficiency (Hamayotsu 2002). The Malaysian experience illustrates how institutional coordination and proactive regulatory intervention can significantly enhance the effectiveness of Islamic liquidity instruments.

Despite these achievements, the study finds that Islamic liquidity management remains inherently dependent on institutional support. Unlike conventional liquidity markets that often operate through deep and highly liquid market mechanisms, Islamic liquidity systems frequently require active involvement from regulators and central banks to maintain functionality (Campello et al. 2011). This reliance suggests that the effectiveness of Islamic liquidity instruments is influenced not only by their design but also by the broader institutional environment within which they operate. Consequently, future development efforts must extend beyond product innovation and focus on strengthening market infrastructure, enhancing regulatory harmonization, and promoting cross-border liquidity integration.

Looking forward, technological innovation presents significant opportunities for improving Islamic liquidity management. The emergence of financial technology (fintech), blockchain-based financial infrastructure, and tokenized assets has the potential to address several structural limitations currently affecting Islamic liquidity markets. Digital platforms can facilitate real-time liquidity matching, reduce transaction costs, and improve market transparency. Likewise, tokenized sukuk could increase secondary market participation by enabling fractional ownership and more efficient trading mechanisms. Blockchain technology may further enhance transaction efficiency by reducing settlement risks and improving the traceability of asset-backed transactions (Kunhibava et al. 2024). These innovations have the potential to transform Islamic liquidity management by increasing market accessibility and reducing operational frictions.

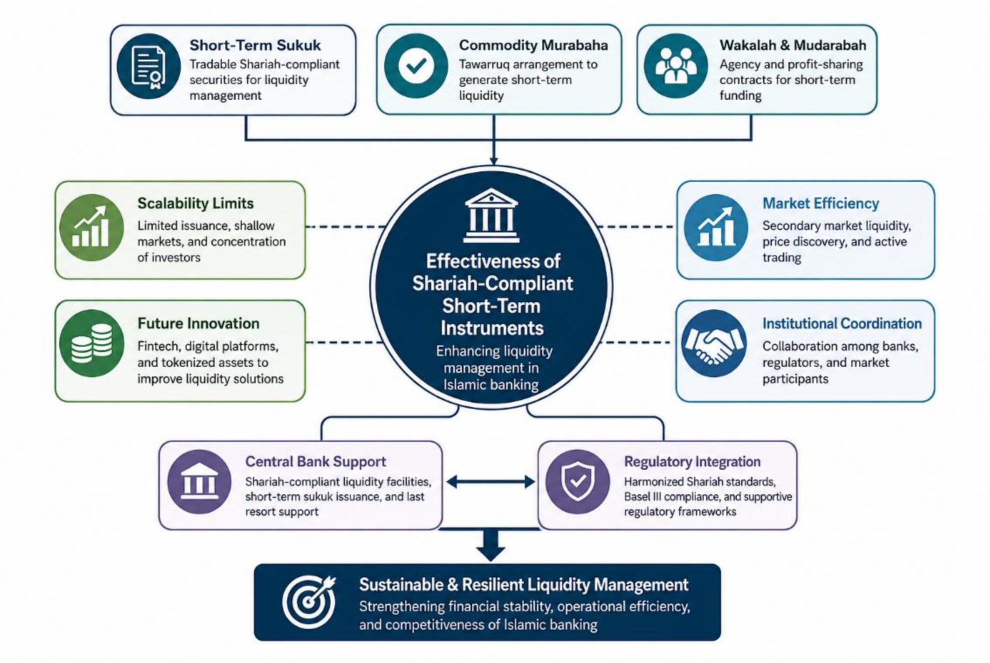

Figure 1 Effectiveness of Shariah-Compliant Short-Term Instruments and Future Directions

Overall, the findings indicate that existing Shariah-compliant liquidity instruments have played a vital role in supporting the growth and stability of Islamic banking. Nevertheless, their effectiveness remains constrained by limited market depth, regulatory fragmentation, operational complexity, and insufficient institutional integration. Future progress will depend on a combination of regulatory harmonization, market development, technological innovation, and enhanced collaboration among financial institutions, regulators, and standard-setting bodies. By addressing these challenges, Islamic finance can move closer to achieving a liquidity management framework that balances Shariah compliance with the efficiency and resilience required in modern global financial markets.

Conclusion

This study demonstrates that liquidity management remains one of the most significant challenges in Islamic banking due to structural, regulatory, and institutional constraints. Unlike conventional banks that benefit from highly developed money markets and a wide range of liquidity instruments, Islamic banks operate within Shariah principles that restrict the use of interest-based mechanisms. Consequently, Islamic financial institutions often face difficulties in accessing efficient short-term liquidity solutions while simultaneously maintaining regulatory compliance and financial stability.

The findings reveal that existing Shariah-compliant instruments, including short-term sukuk, commodity murabaha (tawarruq), wakalah, and central bank liquidity facilities, provide important mechanisms for managing liquidity. However, their effectiveness remains limited by insufficient market depth, lack of standardization, operational complexity, and fragmented Shariah interpretations across jurisdictions. These challenges contribute to a persistent gap between liquidity demand and available liquidity solutions within Islamic financial markets.

The study further highlights that effective liquidity management depends not only on the availability of financial instruments but also on the strength of supporting institutions, regulatory frameworks, and market infrastructure. The Malaysian experience illustrates how coordinated regulatory policies and well-developed Islamic money markets can enhance liquidity efficiency and financial resilience.

Ultimately, strengthening liquidity management in Islamic banking requires greater harmonization of Shariah standards, expansion of Shariah-compliant high-quality liquid assets, deeper Islamic money markets, and continuous financial innovation. Future developments in fintech, blockchain technology, and tokenized sukuk may offer promising opportunities to improve liquidity efficiency while preserving Shariah compliance. Such efforts are essential to enhance the resilience, competitiveness, and long-term sustainability of the global Islamic banking industry.

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Disclosure Statement

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