Sukuk Market Development and Financial Stability in Islamic Banking: A Multi-Theoretical Conditional Framework

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ABSTRACT

Islamic banks (IBs) operate under structural liquidity vulnerabilities arising from the strict prohibition of riba (interest), an acute scarcity of Shariah-compliant High-Quality Liquid Assets (HQLA), and cross-jurisdictional legal fragmentation between Middle Eastern and Southeast Asian regulatory environments. While the expansion of the sukuk (Islamic bond) market is positioned as an indispensable institutional mechanism to alleviate maturity transformation risks and absorb unexpected liquidity shocks, existing empirical literature remains divided between the institutional complementarity hypothesis and the competition-fragility disintermediation narrative. This paper develops a conceptual framework examining the transmission mechanisms of Sukuk Market Development (SMD) to Islamic bank financial stability (operationalized through Roy's distance-to-default Z-Score) across short-run and long-run horizons. Integrating Roy's Principle of Safety First, Keeley's Competition-Fragility Hypothesis, Boyd and De Nicoló's Competition-Stability model, Modern Intermediation Theory, and the Too-Big-To-Fail (TBTF) paradigm, we formulate testable theoretical propositions capturing the continuous moderating roles of market competition (measured via the Lerner Index) and bank asset size. The conceptual model demonstrates that while capital market deepening may create short-run operational frictions and competitive risk-shifting under intense market rivalry, it enhances long-run institutional soundness by providing standardized secondary liquidity and facilitating regulatory capital accumulation. The framework bridges theoretical and empirical gaps in Islamic banking research, offering actionable strategic insights for bank treasury executives and policy recommendations for central banks and macroprudential regulators overseeing dual-banking financial systems.

Keywords: Sukuk Market Development, Bank Financial Stability, Z-Score, Islamic Banking, Market Competition, Bank Size.

INTRODUCTION

The global Islamic financial services industry (IFSI) has experienced remarkable growth over the past three decades, evolving into a multitrillion-dollar financial architecture comprising commercial banking, capital markets, money markets, and takaful operations. Historically dominated by commercial banking, which accounts for over 70% of total industry assets across more than 17 systemically important domestic jurisdictions, Islamic financial institutions operate on ethical and legal principles derived from Islamic jurisprudence (*Shariah*). These include equitable risk-sharing, contractual certainty, and mandatory tangible economic asset backing, alongside strict prohibitions against interest (*riba*), excessive contractual ambiguity (*gharar*), and gambling (*maysir*). Despite demonstrating notable resilience during conventional macro-financial crises, Islamic banks (IBs) continue to face an ongoing structural dilemma: the management of balance-sheet liquidity risk and solvency stability.

Unlike conventional banks that enjoy frictionless access to central bank discount windows, liquid interest-bearing treasury bills, and deep interbank money markets, Islamic banks have been historically constrained

by an excess liquidity dilemma. Because conventional monetary instruments are interest-bearing and thus *Shariah*-prohibited, Islamic banks in numerous jurisdictions encounter a persistent scarcity of *Shariah*-compliant avenues for placing short-term surplus funds. To prevent catastrophic maturity mismatches between short-term customer deposits and long-term financing commitments, IBs are compelled to maintain substantially higher liquidity ratios and unremunerated cash buffers than conventional institutions. This idle cash drag depresses asset productivity and leaves institutions structurally exposed to funding shocks.

This institutional dilemma is compounded by cross-jurisdictional legal and *Shariah* fragmentation. In the Gulf Cooperation Council (GCC) and Middle Eastern jurisdictions governed largely by standards from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), regulatory consensus mandates strict tangible asset backing and explicitly prohibits the trading of debt receivables (*bay' al-dayn*) for cash. Conversely, Southeast Asian regulators, most notably Malaysia's Securities Commission (SC), permit the securitization and secondary trading of established receivables (*mustaqir*) under structured transactional guidelines. Because liquidity instruments structured in Southeast Asia are frequently rejected by Middle Eastern scholars, the Islamic financial services industry lacks an integrated, cross-border secondary liquidity market, confining banks to shallow domestic environments.

In response to this structural impasse, the development of the sukuk (Islamic securities) market has emerged as a cornerstone policy initiative. Representing undivided beneficial ownership in tangible assets, usufructs, or services, the global sukuk market has expanded beyond USD 900 billion in outstanding volume. For Islamic banks, an expanding domestic sukuk market provides an indispensable source of eligible High-Quality Liquid Assets (HQLA) mandated by Basel III and the Islamic Financial Services Board (IFSB). Sovereign and high-grade corporate sukuk offer yield-generating, tradable alternatives to idle cash reserves, allowing banks to diversify asset portfolios and manage liquidity stress without relying on fire-sales. Furthermore, an active sukuk market provides a mechanism for banks to issue subordinated Tier 1 and Tier 2 capital sukuk to absorb unexpected losses and strengthen solvency buffers.

However, the systemic implications of sukuk market expansion on banking stability are complex and contested. Under the complementarity mechanism, deep sukuk markets reduce bid-ask spreads, increase secondary trading liquidity, and lower the liquidity premium on Islamic assets, directly reinforcing bank soundness. Conversely, the disintermediation and competition-fragility hypothesis warns that capital market growth creates intense competitive pressure. High-grade, large-scale corporate borrowers bypass bank financing in favor of issuing corporate sukuk directly to institutional investors. Stripped of their most creditworthy corporate clients, banks face compressed margins and may be driven by competitive pressures to engage in aggressive risk-shifting, allocating credit toward lower-tier, unrated, and opaque private enterprises. This adverse selection process threatens to inflate non-performing financing (NPF) and elevate bank insolvency risk.

Empirical literature examining this nexus reflects this theoretical tension. Pioneering studies by Smaoui et al. (2020) and Smaoui and Ghouma (2020) reveal that sukuk market development increases insolvency risk and erodes capital ratios for pure Islamic banks, particularly during periods of macroeconomic stress. In sharp contrast, Ledhem (2022) demonstrates that sukuk market development significantly enhances the financial stability (Z-Score) of Islamic banks across leading jurisdictions via institutional complementarity. Recent causality findings by Hassan et al. (2025) establish that sukuk issuances enhance liquidity and reduce non-performing loans yet leave direct operational margins unaffected. These unresolved controversies stem from an overreliance on static, direct-effect models that ignore the conditioning roles of market competition and bank asset size, as well as the failure to separate short-run transitional frictions from long-run structural cointegration.

To resolve these controversies, this paper constructs a conceptual framework focused specifically on the financial stability of Islamic banks. We formulate testable theoretical propositions addressing three core objectives: (1) modeling the direct transmission of sukuk market development to bank stability (Z-Score) across short-run and long-run horizons; (2) conceptualizing how market competition (Lerner Index) conditionally moderates this stability relationship; and (3) determining how bank asset size moderates stability outcomes across multi-horizon timeframes. By synthesizing Roy's Principle of Safety First,

Industrial Organization competition theories, and Modern Intermediation versus Too-Big-To-Fail frameworks, this paper provides a robust theoretical foundation for future empirical inquiry.

THEORETICAL FOUNDATIONS

To build a rigorous conceptual model of Islamic bank stability, this study synthesizes three foundational theoretical traditions: Roy's Principle of Safety First, Industrial Organization theories of competition and fragility, and the scale-versus-moral-hazard paradigms of bank size.

Roy's Principle of Safety First and the Structural Z-Score

The theoretical grounding of institutional solvency is rooted in Roy's (1952) Principle of Safety First. Roy departed from classical expected-wealth maximization, arguing that under real-world conditions of uncertainty and catastrophic risk, economic agents prioritize the avoidance of disaster over the pursuit of speculative gain. An optimizing decision-maker selects an asset allocation that minimizes the probability that operating return (m) falls below a critical disaster threshold (d). In banking literature, this behavioral rule provides the exact microeconomic foundation for the Bank Z-Score (Rajhi & Hassairi, 2013). By defining the operational disaster threshold (d) as the point of capital exhaustion, where operating losses completely wipe out the bank's equity capital base, such that $d = -E/A$ (where E represents total equity and A denotes total assets), the safety index transforms into the structural Z-Score, which is:

Z-Score: [ROA + (E/A)] / σ(ROA).

The Z-Score measures the distance from insolvency in units of standard deviations of return on assets (σ(ROA)). It is inversely related to the probability of default: a higher Z-Score reflects greater distance from insolvency and superior stability. The metric is reinforced by three balance-sheet levers: higher operational profitability (ROA), stronger capitalization buffers (E/A), and reduced return volatility (σ(ROA)). Sukuk market development directly interacts with each of these three levers: on the asset side, sovereign and corporate sukuk provide yield-bearing, *Shariah*-compliant liquid alternatives to idle central bank cash, raising ROA without proportional additions of illiquid credit risk; on the liability side, an active sukuk market allows banks to issue capital sukuk, expanding the equity buffer (E/A); and deep secondary sukuk trading markets provide immediate liquidity transformation, preventing fire-sale losses during liquidity panics and dampening earnings volatility (σ(ROA)).

Competition, Market Power, and Financial Soundness: CFH versus CSH

The impact of capital market expansion on banking stability is critically conditioned by the competitive environment within the banking sector. The banking literature features two sharply opposing theoretical traditions regarding competition and stability: firstly, the Competition-Fragility Hypothesis (CFH). Keeley (1990) argues that heightened market competition erodes bank franchise values and depresses profit margins. When charter values decline, bank managers have less capital at stake to lose in the event of default, creating moral hazard. To restore profitability, banks lower credit standards, underwrite higher-risk financing, and reduce equity capital cushions. Consequently, intense competition directly breeds systemic fragility. Secondly, the Competition-Stability Hypothesis (CSH), where Boyd and De Nicoló (2005) challenge the CFH by focusing on borrower behavior. They demonstrate that when banks possess high market power and face low competition, they charge exorbitant financing markups. These high financing costs strain borrower cash flows and incentivize borrowers to select riskier investment projects (risk-shifting problem), ultimately increasing borrower defaults and bank insolvency risk. Thus, increased competition lowers financing rates, reduces moral hazard, and enhances banking stability. Following modern empirical banking methodology, market competition is measured inversely through the Lerner Index of market power, which computes the proportional markup of financing output prices above marginal operating costs. Higher Lerner values reflect greater market power and lower competitive intensity.

Bank Size: Modern Intermediation versus Too-Big-To-Fail Distortions

The relationship between bank asset size and financial stability is governed by the structural tension between operational economies of scale and regulatory moral hazard. Based on Modern Financial Intermediation Theory which is grounded in Gurley and Shaw (1960), Benston and Smith (1976), and Baumol et al. (1982), this framework posits that large intermediaries achieve substantial efficiency gains by spreading fixed informational and compliance overheads over a broad asset base. Furthermore, large banks achieve superior portfolio diversification across economic sectors and geographical markets, significantly reducing default correlation and dampening the volatility of asset returns (σ(ROA)). On the other hand, the Too-Big-To-Fail (TBTF) or Size-Related Subsidy Theory, which was pioneered by Kaufman (1977) and Boyd and Runkle (1993), warns that large, systemically important banks benefit from implicit state guarantees. Anticipating regulatory bailouts in periods of systemic distress, large bank executives face distorted incentives to take on excessive leverage, engage in complex speculative capital market trading, and maintain thinner capital buffers. In the presence of new financial markets like sukuk, large banks may engage in aggressive, highly leveraged secondary trading, creating short-term balance-sheet fragilities.

Multi-Horizon Dynamics and Continuous Marginal Moderation

To accurately conceptualize institutional stability, two critical analytical principles must be integrated into the framework. First, following modern conditional effects theory (Brambor, Clark, & Golder, 2006; Preacher & Hayes, 2008), the interaction between sukuk market development and a continuous moderator (such as competition or size) cannot be evaluated by examining an unconditioned interaction coefficient in isolation. The true marginal effect varies continuously across the full range of the moderator. Calculating conditional marginal derivatives and standard error bands is essential to identify the precise empirical thresholds where capital market deepening transitions from an institutional hazard into a stability catalyst.

Second, the transmission of capital market forces differs across temporal horizons. In the short run, rapid sukuk market growth introduces operational and contractual frictions: banks must adjust treasury protocols, rewrite risk management models, and navigate secondary market price volatility. In the long run, transitional frictions subside, allowing institutions to reach a steady-state structural equilibrium where scale economies, portfolio diversification, and HQLA liquidity absorption dominate. Conceptualizing these forces within an autoregressive distributed lag framework captures these multi-horizon dynamics.

EMPIRICAL LITERATURE REVIEW AND RESEARCH GAPS

The empirical literature evaluating the link between sukuk market development and banking performance is summarized in Table 1 below.

Table 1. Summary of Empirical Literature on SMD and Banking Performance

Author (Year)	Sample & Period	Methodology	Dependent Variable	Independent & Moderating Variables	Key Stability & Risk Findings
Mimouni et al. (2019)	71 IBs & 146 CBs across 13 countries (2003–2014)	Dynamic System-GMM	Bank Profitability (NPM, ROA)	SMD (Sukuk/GDP), Market Power (Lerner), Bank Size	SMD negatively impacts IB profitability due to corporate disintermediation. Low profitability indirectly threatens capital accumulation.
Smaoui & Ghouma (2020)	230 IBs & CBs across 13	System-GMM & Prais-	Bank Capitalization	SMD (Sukuk/GDP),	SMD negatively affects IB capital

	countries (2005–2014)	Winsten	(CAR, Tier 1 ratio, Capital/Assets)	Competition (H-statistic), Bank Size	ratios. SMD × Competition is negative and significant, but marginal effects were not computed.
Smaoui et al. (2020)	72 IBs & 145 CBs across 15 countries (2003–2014)	Dynamic System-GMM	Insolvency Risk (Z-Score)	SMD (Sukuk/GDP), Market Power (Lerner), Bank Size	SMD significantly increases insolvency risk for pure IBs. Large IBs display higher insolvency risk. Interaction terms omitted marginal thresholds.
Ledhem (2022)	IFIs in Malaysia, Saudi Arabia, Indonesia, Brunei, Turkey (2013–2019)	Dynamic Panel System-GMM	Financial Stability (Z-Score)	SMD (Sukuk issued), Bank Size, Macro Controls	SMD positively affects IB financial stability via institutional complementarity and liquidity diversification. Model omitted interaction terms.
Hassan et al. (2025)	Quarterly panel across 12 countries (2013–2024)	Fourier Panel Causality	Liquidity (LAR), Credit Risk (NPL), Profitability.	Total Sukuk Issuance, Macro Controls	Sukuk issuances significantly enhance bank liquidity and reduce NPLs, supporting stability. The model did not test conditional moderation structures.

Synthesis of Gaps in the Stability Literature

The empirical divergence paradox is one of the primary gaps in the stability literature, where existing studies remain divided between conflicting empirical outcomes. Smaoui et al. (2020) conclude that sukuk market expansion increases insolvency risk for Islamic banks, whereas Ledhem (2022) finds a strong positive complementarity effect on bank Z-scores, and Hassan et al. (2025) find significant reductions in credit risk. A conceptual framework is needed to reconcile these opposing empirical findings through temporal and conditional mechanisms. Moreover, there is a lack of marginal moderation analysis in prior methodologies. Studies have treated market competition and bank asset size almost entirely as direct linear control variables. Where interactive terms were introduced (e.g., Smaoui & Ghouma, 2020; Smaoui et al., 2020), researchers evaluated only the isolated interaction coefficient without calculating conditional marginal effects or standard-error significance plots across the moderator distribution, violating modern interaction methodology (Brambor et al., 2006).

Meanwhile, previous empirical research has relied on micro-panel System-GMM estimators (N > T), which impose slope homogeneity and assume cross-sectional independence, assumptions routinely violated in multi-country Islamic banking data subject to common macroeconomic shocks. Most importantly, GMM aggregates short-run adjustment frictions and long-run steady-state cointegration into a single static parameter, obscuring how bank stability evolves across time.

Conceptual Framework and Research Propositions

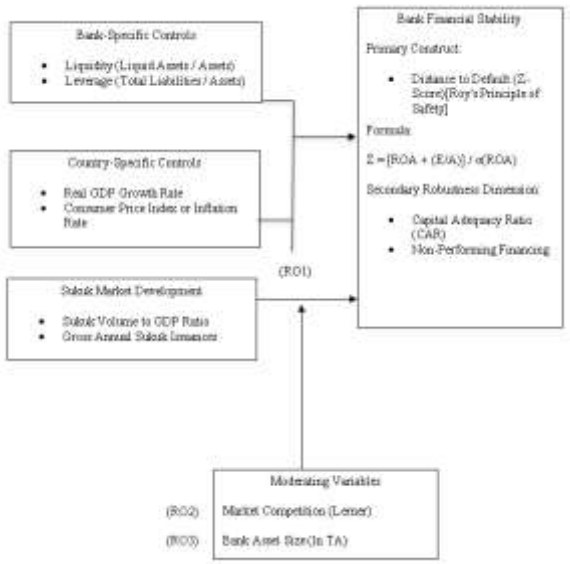
Figure 1 presents the formalized conceptual framework modeling the transmission of Sukuk Market Development to Islamic Bank Financial Stability, conditioned by Market Competition and Bank Asset Size, alongside bank-specific and macroeconomic controls. We use the term proposition because this study is a theory-building conceptual framework designed to guide future empirical testing.

Direct Effects: Sukuk Market Development and Bank Stability (RO1)

The direct relationship between sukuk market development and Islamic bank stability operates through liquidity transformation, portfolio diversification, and capital accumulation channels. By examining the moderating effect of competition and bank size using the CS-ARDL approach, which captures both short- and long-run dynamics in the context of top sukuk-issuer countries, this study makes a specific contribution to the literature. In the short run, the rapid expansion of domestic sukuk issuance can create operational and portfolio-rebalancing frictions. Treasury desks must adjust asset allocations and absorb short-term secondary market price fluctuations. However, because sovereign and high-grade corporate sukuk provide immediate, tradable High-Quality Liquid Assets (HQLA), banks reduce their vulnerability to sudden liquidity runs, preventing fire-sale losses. Meanwhile, over the long-run horizon, the institutional complementarity mechanism becomes fully realized. A mature, liquid secondary sukuk market eliminates the chronic liquidity drag that has historically plagued Islamic banks, allowing them to redeploy non-earning cash reserves into yield-bearing, investment-grade assets. This steady revenue stream stabilizes operating returns and dampens asset return volatility (σ(ROA)).

Furthermore, banks utilize the sukuk market to issue capital sukuk to institutional investors, substantially expanding their equity capital buffers (E/A). Consequently, distance to default (Z-Score) increases substantially over both horizons, with long-run structural gains surpassing short-run adjustments. Proposition 1 (P1): *Sukuk market development exerts a statistically significant positive effect on Islamic bank financial stability (Z-Score) across both the short run and the long run, with the magnitude of stability gains expanding in the long run as secondary market liquidity dampens asset return volatility (σ(ROA)) and facilitates regulatory capital buffer expansion (E/A).*

Figure 1. Conceptual Framework for Islamic Bank Financial Stability



Moderating Role of Market Competition: Fragility versus Stability (RO2)

The competitive environment operationalized inversely through the Lerner Index of market power, critically conditions the impact of sukuk market expansion on stability. Under intense market competition (low Lerner Index), the disintermediation pressures generated by capital market deepening become severe. As blue-chip corporate borrowers migrate from bank financing to corporate sukuk issuances, competing banks face compressed net financing markups. In line with Keeley's (1990) Competition-Fragility Hypothesis, banks attempt to defend earnings by adopting aggressive risk-taking behavior, shifting credit allocation toward lower-quality, unrated private borrowers who lack access to capital markets. This adverse selection dynamic increases non-performing financing (NPF) and impairs capital cushions, causing sukuk market development to reduce the distance to default (Z-Score).

Conversely, in markets characterized by high market power (high Lerner Index), Islamic banks retain pricing discretion. These institutions can maintain healthy financing-deposit spreads, absorb corporate disintermediation shocks, and act as primary underwriters and market-makers for new sukuk tranches. In accordance with the Market Power Hypothesis and Boyd and De Nicoló's (2005) framework, market power insulates bank profitability and provides the necessary capital cushions to enhance institutional stability as the capital market deepens.

Proposition 2a (P2a): *Market competition conditionally moderates the relationship between sukuk market development and Islamic bank stability: under intense competition (low Lerner Index), sukuk market growth significantly increases insolvency risk (lowers Z-Scores) as banks engage in adverse risk-shifting toward lower-quality borrowers.*

Proposition 2b (P2b): *Under conditions of low competition (high Lerner Index), sukuk market development significantly enhances bank stability (increases Z-Scores) by reinforcing capital buffers and preventing aggressive risk-taking behavior.*

Moderating Role of Bank Asset Size: Scale Economies versus TBTF (RO3)

Bank asset size conditions the transmission of capital market deepening through operational scale economies and regulatory risk distortions. Under Modern Intermediation Theory (Gurley & Shaw, 1960; Benston & Smith, 1976), large Islamic banks possess the balance-sheet capacity, specialized treasury units, and institutional reputation required to fully exploit capital market deepening. Large banks can absorb sovereign and corporate sukuk tranches on scale, establish active secondary trading desks, and access international institutional investor pools for their own capital sukuk issuances. In the long run, this scale advantage translates into superior portfolio diversification, lowering default risk and dampening earnings volatility (σ(ROA)). Small Islamic banks, burdened by high fixed compliance overheads and excluded from large capital market syndications, realize smaller stability gains.

However, in the short run, bank size introduces contrasting vulnerabilities consistent with the Too-Big-To-Fail (TBTF) hypothesis (Kaufman, 1977; Boyd & Runkle, 1993). Because large, systemically important banks operate under implicit government safety nets, their treasury desks are incentivized to pursue aggressive, speculative secondary trading and complex balance-sheet structures in newly issued sukuk instruments. During initial market expansion, these speculative activities expose large banks to heightened short-term valuation swings and secondary market liquidity frictions, temporarily reducing their distance to default. Over the long run, operational scale and portfolio diversification reassert themselves, establishing a positive relationship between bank size, capital market development, and institutional stability.

Proposition 3a (P3a): *Bank asset size exhibits a multi-horizon conditional moderating effect on bank stability: in the short run, larger asset size diminishes the stability gains of sukuk market development due to complex portfolio rebalancing frictions and Too-Big-To-Fail speculative risk-taking.*

Proposition 3b (P3b): *In the long run, bank asset size significantly and positively moderates the relationship between sukuk market development and bank stability, as large institutions convert scale economies,*

secondary market underwriting, and portfolio diversification into superior distance-to-default robustness (higher Z-Scores).

Construct Operationalization and Future Empirical Agenda

To support future empirical testing of the conceptual propositions developed in the previous section, Table 2 describes the variables, including their operational definitions, measurement proxies, and theoretical linkages within the stability framework.

Table 2. Description of Variables

Variable Role	Construct Name	Operational Proxy / Formula	Expected Data Source	Theoretical Underpinning
Dependent Variable (RO1)	Bank Financial Stability	Z-Score = [ROA + (E/A)] / σ(ROA) Robustness: Non-Performing Financing (NPF), Capital Adequacy Ratio (CAR)	BankFocus / FitchConnect / Audited Annual Reports/IFSB	Roy's (1952) Principle of Safety First; Distance to Insolvency Default
Independent Variable (RO1)	Sukuk Market Development (SMD)	Sukuk Market Development = Sukuk/ GDP (%) Sukuk = Outstanding Sukuk Or Sukuk Issuance Volume	IIFM Sukuk Reports / IFSB / Bloomberg / Refinitiv	HQLA Supply & Liquidity Management vs Disintermediation
Moderator 1 (RO2)	Market Competition	Lerner Index of Market Power (L = [P - MC] / P) Robustness: Panzar-Rosse H-Statistic	Estimated via Translog Cost Function (Bank-level data)	Competition-Fragility (Keeley,1990) vs Competition-Stability (Boyd & De Nicoló, 2005)
Moderator 2 (RO3)	Bank Asset Size	Natural Logarithm of Total Assets (ln TA)	Bank Balance Sheets / Financial Statements/IFSB	Modern Intermediation Theory (Scale Economies) vs Too-Big-To-Fail (TBTF)
Control (Bank-Specific)	Liquidity & Leverage	LAR = Liquid Assets / Total Assets LEV = Total Liabilities / Total Assets	Bank Balance Sheets/IFSB	Structural balance-sheet inventory holding and liability adjustment frictions
Control (Macroeconomic)	Economic Growth & Inflation	Annual Real GDP Growth Rate (%) Consumer Price Index Inflation Rate (%)	World Bank (WDI) / IMF (IFS)/Refinitiv	Macro-financial cycle shocks and exogenous credit demand

Methodological Recommendations for Future Empirical Testing

In evaluating this conceptual model empirically, future researchers should use estimation techniques that account for the unique structural characteristics of cross-country Islamic banking data, such as multi-horizon dynamic estimation. Because our propositions explicitly differentiate short-run adjustment frictions from long-run steady-state cointegration, empirical studies should avoid static panel estimators. Researchers are encouraged to implement dynamic heterogeneous panel frameworks, such as the Cross-Sectionally

Augmented Autoregressive Distributed Lag (CS-ARDL) approach (Chudik & Pesaran, 2015). This technique accounts for cross-sectional dependence arising from global macroeconomic cycles while estimating distinct short- and long-run parameters. This approach also considers heterogeneous panels with mixed orders of integration.

Future researchers can also consider continuous marginal effects and threshold modelling in the study. In order to test the moderating propositions (P2a, P2b, P3a, P3b), researchers must move beyond examining the statistical significance of isolated interaction terms. Following Brambor, Clark, and Golder (2006), empirical analyses should compute conditional marginal effects along with 95% confidence bands across the full distribution of the moderating variables. This approach will allow researchers to identify the exact empirical threshold where capital market deepening shifts from an operational hazard to a stability enhancer.

DISCUSSION, IMPLICATIONS, AND FUTURE RESEARCH AGENDA

The conceptual model developed in this paper provides a theoretical reconciliation of conflicting literature in Islamic banking stability. By establishing that the destabilizing competition-fragility effects observed by Smaoui et al. (2020) and the stabilizing complementarity gains observed by Ledhem (2022) are governed by underlying competitive structures and institutional scale thresholds, this paper shows that these empirical outcomes are parts of a unified adjustment process. Sukuk market development does not exert an unconditional effect on bank stability; rather, its impact depends on the bank's competitive insulation and asset size.

For Islamic bank executives, the model emphasizes the strategic need to transform liquidity risk management from a passive compliance exercise into an active treasury strategy. Institutions should leverage secondary sukuk markets to actively optimize Basel III and IFSB Liquidity Coverage Ratios (LCR) and Net Stable Funding Ratios (NSFR). Furthermore, bank executives must utilize the sukuk market to issue capital sukuk to build loss-absorbing capital cushions. Smaller Islamic banks, which face competitive disintermediation without the scale to underwrite major issuances, must actively pursue strategic mergers or establish consortium-based syndication desks to achieve the critical mass required for capital market participation.

For central banks, the IFSB, and AAOIFI, this framework provides three urgent policy imperatives: (1) establish standing, Shariah-compliant open market and repurchase (repo) facilities based on sovereign sukuk to serve as a formal lender-of-last-resort mechanism for Islamic banks; (2) harmonize cross-border Shariah standards between the Middle East and Southeast Asia to facilitate secondary sukuk trading and global liquidity sharing; and (3) enforce size-proportionate supervision that monitors risk-shifting behavior among mid-sized Islamic banks operating under intense sukuk market competition.

Future empirical research should operationalize this framework across top sukuk-issuing jurisdictions using the proposed multi-horizon panel methodology. Further inquiries should also investigate structural distinctions between asset-backed (true sale) and asset-based sukuk, and assess how the emerging expansion of green and sustainability sukuk reshapes bank performance and systemic stability.

CONCLUSION

This paper has established a conceptual framework examining the impact of sukuk market development on Islamic bank financial stability. Grounded in Roy's Principle of Safety First, Industrial Organization competition theories, and Modern Intermediation versus Too-Big-To-Fail paradigms, our framework models the multi-horizon direct transmission channels and continuous moderating mechanisms of market competition and bank asset size. By offering a comprehensive theoretical structure and clear operationalization agenda, this paper provides a robust foundation for future empirical research and macroprudential policymaking in the Islamic financial services industry.

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