

# Application of The Contents of Corporate Governance in The Practice of Risk Management in Islamic Banks

Prepared by

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## Abstract

*The paper dealt with the application of the contents of corporate governance in the practice of risk management in Islamic banks according to the rules of corporate governance (protection of shareholders' rights, the responsibilities of the board of directors, disclosure and transparency, the role of stakeholders, the environment of control and control). The study used descriptive and analytical methods to answer its questions. The study community consisted of all three employees of Islamic banks in Jordan. A random sample of (100) employees of the three banks was selected, which is 2973<sup>(1)</sup> employees in 2017. The study found that there is a positive impact when applying the contents of corporate governance in the practice of risk management in Islamic banks. Recommended the adoption of corporate governance standards and rules based on scientific and jurisprudential consolidation and standardization of rules and regulations governing banking relations between banks and stakeholders.*

**Keywords:** governance dimension, governance and risk, the advantage of governance

GEL Classification, G01, G3, G21, G24

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(1): Records of the Association of Banks in Jordan for the year (2017/2018), the Hashemite Kingdom of Jordan.

## 1. Introduction

Rapid developments in the modern production community, such as increased interbank competition, rapid technological progress, diversification of customer needs, and financial market risks, have shown inadequate traditional and managerial methods of

maintaining and maintaining funds and balancing profits and risks. Financial crises and collapses the financial institutions were exposed to many cases of corruption, which led to studies to identify the main reasons behind their occurrence and to propose ways to prevent or approach them. Studies found that the majority of these reasons were Financial, administrative and accounting reasons, and recommended the adoption of a set of accounting standards consistent with the shareholders and stakeholders, and helps them to make right economic decisions, within the framework of corporate governance based on a set of general principles, which help overcome business risks and increase productivity Traditional and Islamic banks.

## **2. Research problem**

The adoption of good corporate governance practices leads to a better control system, and greater accountability and transparency, better profit margin and lower risk, enhances the investment environment in the competitive financial market and risks better access to funds and entry into new markets. The problem of this study is On the impact of the application of the contents of corporate governance on the practice of risk management in Islamic banks?

## **3. The importance of the research**

Theoretically, the importance of research in guiding the attention of managers and decision-makers in Islamic banks to the need to strengthen the practice of rules of governance and interest in their application, in the identification and evaluation of risks, and measurement and to develop strategies for management, and take appropriate action for analysis, to control them.

## **4. Research objectives**

Successful management invests risks into opportunities or limits their impact and uses unique strategies for their success. This research aims to study the application of the contents of corporate governance to the practice of risk management in Islamic banks

## **5. Research hypotheses**

Based on the research problem, importance and objectives, the research hypotheses were formulated in the following form:

**H<sub>01</sub>: The first hypothesis: There is no impact on the application of the contents of corporate governance represented in the practice of risk management in Islamic banks.**

**Implications for this hypothesis are the following sub-hypotheses**

- There is no impact of the application of the equity protection rule on the practice of risk management in Islamic banks.
- There is no impact on applying the base rule of board responsibilities to the practice of risk management in Islamic banks.
- There is no impact of the application of the disclosure and transparency rule on the practice of risk management in Islamic banks.
- There is no impact on the application of the rule of guaranteeing the role of stakeholders in the practice of risk management in Islamic banks.

**H<sub>02</sub>: The second hypothesis: There is no effect of applying the rule of the environment of control and control in the practice of risk management in Islamic banks.**

**Ramifications for this hypothesis are the following sub-hypotheses**

- There is no effect on the application of internal control and control systems in the practice of risk management in Islamic banks.
- There is no impact on the application of internal audit in the practice of risk management in Islamic banks.
- There is no impact on the application of external audits in the practice of risk management in Islamic banks.

## **6. Research Methodology**

The researcher, in the light of the importance, objectives and hypotheses, depends on the descriptive-analytical methods in the preparation of the research as follow:

- The first approach is based on extrapolation and analysis of literature (books, letters, Arab and foreign periodicals, and researches on the international information network) related to the intellectual aspects of the research to root scientific research topics.
- The second approach is based on devising a general framework for the subject of the research supporting the requirements of the application.

- The researcher also relies on a survey study using a questionnaire to determine the impact of the governance of risk management practice in four Islamic banks operating in Jordan.

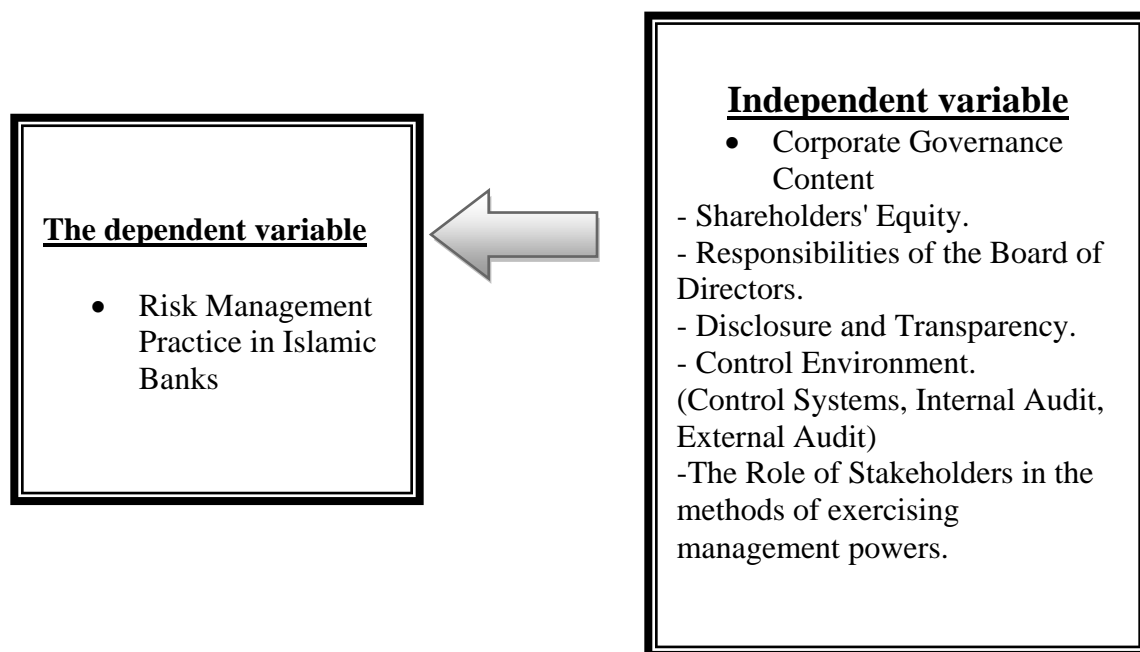
## 7. Research limits

The research limits include a range of spatial and technical limits as follows:

- Spatial limits: The field study was conducted on Islamic banks operating in Jordan
- Technical Limits: The field study was limited to the corporate governance content of shareholders' equity, board responsibilities, disclosure and transparency, control environment, stakeholder role in risk management practice.

## 8. Research model

Based on the research problem, the model is illustrated by the dependent and independent variables as follows:



RM=CG

RM=SHE+RB+DT+CE+RS

- RM =Risk Management Practice in Islamic Banks
- CG=Corporate Governance Content
- SHE=Shareholders' Equity

- RB=Responsibilities of the Board of Directors
- DT=Disclosure and Transparency
- CE=Control Environment.
- RS=The Role of Stakeholders in the methods of exercising management powers

## 9. The theoretical framework for research, And Previous studies

“The importance of banking governance is now increasing in order to achieve economic advantage, provide investors with confidence and provide sources of financing for institutions by relying on the capital markets because of the tremendous speed in the movement of capital flows”(Hajer and Anis, 2018).The Economic Cooperation Organization"OCED" has referred to the basic rules of governance.

- “The existence of an effective corporate governance framework that ensures the efficiency and transparency of financial markets in line with legal, supervisory, and regulatory provisions and the clear distribution of responsibilities”.
- “Equity :Such as the right to obtain the necessary information relevant to the Company's activity on a regular and timely basis, transfer or transfer of ownership of shares, participation in voting, election and obtaining profits, and securing ways of registering property.”
- “Equitable treatment of shareholders: Ensure equal treatment for all shareholders, including foreign shareholders and minority shareholders.”
- “Rule of stakeholders :This involves the recognition of all rights related to stakeholders established by law, the promotion of cooperation between the company and the stakeholders, and the increased ability to access the information required.”
- “Disclosure and Transparency Rule :The importance of governance lies in its strong ability to achieve timely and adequate disclosure on all matters related to the establishment of the company, its operational activities, information on corporate governance policies and structures, benefits and salaries granted to senior officials and members of the board of directors”.

- “Board of Directors' Responsibilities: The practice of corporate governance and strategic guidance and guidance of companies in a manner that ensures accountability of the Board of Directors by the shareholders, and follow-up executive management” (OCED, 2004).

### **The concept of governance in Islamic banks**

The structure of Islamic bank governance is based on Shari'ah's supervision in addition to internal and external control systems. This structure is composed of external regulators, namely shareholders, independent auditors, stock exchanges, corporate law, “the Central Bank of the State, and the Accounting and Auditing Board. Internal control systems such as financial control, process control, auditing, and compliance with Shari'ah reporting standards”. (Kaala,2015,pp.30-31)According to (Buhrawa&Pokrucha, 2015), “Islamic banking structures may be central to Shari'ah governance, such as Malaysia, Indonesia, Syria, Jordan, or the autonomous Islamic governance of most of the Gulf and North Africa, European Islamic finance, or hybrid Shari'ah, as well as banks with a central Shari'ah body.” “The risks facing Islamic banks are divided into the risks they share with traditional banks as financial intermediaries, and the risks they are exposed to because they comply with Islamic law. Most of the risks are market risk, credit, liquidity, risk of loss of confidence in the Islamic Bank, and the risk of non-hedging of derivatives”.(Qulaiti, Garbi, 2017).The study (Jiao et al. 2018).“Provides a theoretical and practical framework for understanding the impact of environmental risks on the performance of new product development in emerging markets because they have a direct and positive impact on the performance of the organization. The results of the study (Chung, et al. 2018)". That government ownership reduces the risk of default and increases operational risk. At the same time, foreign ownership reduces the risk of default and operating, suggested”Celso et al.(2018) that the portfolio of banks should be formed as a function of day-to-day interbank trading and equity returns. Moreover, the measures of systemic risk derived from this approach, in the sense of forecasting, lead to many commonly used risk indicators.“A study(Baniata, 2017) found that

there is a positive effect of Islamic rules governing financial transactions in the performance of Islamic banks”.(Mullahet al. 2017)

Explained that the governance structure of Islamic banks plays a crucial role in risk tolerance as well as the outstanding financial performance of conventional banks. Furthermore, the governance structure of Islamic banks allows them to assume higher risks and achieve better performance. (Al-Hawali& Shadi Salama, 2015)” revealed a strategy for the Bank's management to manage, evaluate, and monitor the risks associated with electronic banking activities." The study of Khidr and Khaydir (2014) “revealed the reasons for banks' interest in global governance and their real role in reducing the repercussions of the global financial crisis, and showed a strong relationship between the global financial crisis and governance." The main reason for the story of the global financial crisis and its consequences is the failure to apply rules Governance, board composition, and risk management.

The researcher believes that the Shari'ah Supervisory Board is the central pillar on which the governance of Islamic banks is based and that the owners of rights are negatively or positively affected by the institutional governance because they have a role in identifying the risks to which the bank is exposed and trying to detect the consequences thereof. Of the risk through unique criteria and criteria for evaluation. Each type of risk has its methods of dealing with it. For example, liquidity risk is one of the most important types of financial risk for Islamic banks. These risks can be due to difficulty in obtaining Reasonable liquidity cost by borrowing, selling assets or immeasurability, and that these risks produce because of economic, political, social or security factors, including currency risk, the prices shall be very dangerous Islamic banks cannot deal as financial derivatives to cover risks. Alternatively, operational risks due to inadequate equipment or technology, operational risk due to errors in model specifications, inaccuracies in the execution of such operations, or the credit risk of the customer itself concerning the nature of his work and activity and inability to pay the due amount to him or the donor bank.

## **10.The field study**

### **10.1Research community**

The study community consists of three Islamic banks operating in Jordan “Arab Islamic International Bank, Jordan Islamic Bank, and Safwa Islamic Bank.”According to the records of the Central Bank of Jordan at the beginning of 2019.

## 10.2 Sample research

A random sample of (100) members of the study's population of 2973 employees was distributed among the three banks. The sample constituted (3.4%) of the study population, according to table No (1):

Table No (1): the sample distribution according to the bank name

Name of the Bank	Arab Islamic International Bank	Jordan Islamic Bank	Safwa Al Islamic Bank	Total
frequencies	32	38	30	100
percentage	%32	%38	% 30	100%

## 11. Test of validity and reliability of the tool used

It has been ascertained that the questionnaire prepared for this research is valid to measure what it has been prepared to measure and it includes all the elements that must be included in the analysis on the one hand and the clarity of paragraphs and vocabulary on the other hand in order to be understood by the respondents through the following:

### 11.1 Virtual sincerity

Virtual sincerity has been confirmed through the distribution of the questionnaire on the number of arbitrators to know the extent of its sincerity in measuring research variables. The number of arbitrators is (10) from the Faculty of Economics at the Jordan Universities. In light of arbitrators' opinions, some phrases have been modified, some have been deleted, some have been reworked, and others have been added.

### 11.2 The reliability of the questionnaire

Reliability testing was conducted on sample research by using the coefficient of Alpha Cronbach. The Alpha Cronbach values range between (0-1), and in order



to be characterized reliably, the minimum value for coefficient must be not less than (0,70). Table (2) shows the results of the analysis of the Alpha Cronbach coefficient for each part of the questionnaire.

Table (2): Alpha Cronbach coefficient for each part of the questionnaire

Part of the questionnaire	The application of the rules of governance	The practice of risk management in Islamic banks	All parts
Alpha Cronbach	0.90	0.80	0.91

We notice from Table (2) that the value of Alpha Cronbach coefficient for the questionnaire parts ranging from (0.80) for the variables phrases part of cost advantage, and (0.91) for the variables phrases part of the quality advantage. This ranging means that the value of the Alpha Cronbach coefficient for all parts of the questionnaire is greater than (0.70). This indicates that the research tool characterized by internal consistency between its phrases. The value of the coefficient Alpha Cronbach for total phrases questionnaire has reached (0.91), and this value is high, which in turn indicates that the degree of stability is well characterized by the questionnaire, which is valid.

## 12.Data analysis

The degree of relevance of assessment was calculated on the basis that the length of the period = (the upper limit of the alternative - the minimum of the alternative) / the number of levels =  $(5-1) / 3 = 4/3 = 1.33$ . ShowsTable (3)

Table (3): Determination of the level of relevance of the arithmetic mean

mean	1-less than2.33	2.33 less than3.6	3.67 less than5
assessment	Low	Medium	High

Table (4) shows that the statistical averages of the respondents' responses to the paragraphs of the first hypothesis ranged from 4.25-4.34 to a high level for all variables. The practice of applying the role of stakeholders was ranked first, while the practice of applying the rules of disclosure and transparency ranked last.

**Table (4):The degree of application of the rules of governance in the practice of risk management in Islamic banks**

<b>degree</b>	<b>percentage</b>	<b>standard deviation</b>	<b>mean</b>	<b>Variables</b>	<b>Rank</b>
<b>High</b>	<b>%86.2</b>	<b>0.66</b>	<b>4.27</b>	Application of the rules of shareholders' equity	<b>3</b>
<b>High</b>	<b>%86.4</b>	<b>0.27</b>	<b>4.32</b>	Exercise the responsibilities of the Board of Directors	<b>2</b>
<b>High</b>	<b>%85</b>	<b>0.42</b>	<b>4.25</b>	Practice the application of disclosure and transparency rules	<b>4</b>
<b>High</b>	<b>%86.8</b>	<b>0.47</b>	<b>4.34</b>	Practice the application of ensuring the role of stakeholders	<b>1</b>

Table (5) shows that the statistical averages of the responses of the sample members on the second hypotheses ranged from 4.19-4.32 to a high level for all variables.

**Table (5): Control and Control Environment in the Practice of Risk Management in Islamic Banks**

<b>degree</b>	<b>percentage</b>	<b>standard deviation</b>	<b>mean</b>	<b>Variables</b>	<b>Rank</b>
<b>High</b>	<b>85.2</b>	<b>0.44</b>	<b>4.26</b>	<b>Control and control systems</b>	<b>2</b>
<b>High</b>	<b>86.4</b>	<b>0.44</b>	<b>4.32</b>	<b>Internal Control</b>	<b>1</b>
<b>High</b>	<b>83.8</b>	<b>0.46</b>	<b>4.19</b>	<b>External Control</b>	<b>3</b>

Table (6) shows that the arithmetic averages of the respondents' responses to the paragraphs of the risk management practice in Islamic banks ranged from 4.36 to 4.66 with a high application rate for all. The average of the axial index as a whole

was 4.43. Islamic banks have a comprehensive strategy on the type and level of acceptable risk for all its activities, "ranked first while the paragraph" Islamic banks' approach to risk management is a clear policy commensurate with the size and specificity of the bank."

**Table (6): Risk Management Practice in Islamic Banks "ranked in descending order according to the average**

degree	percentage	standard deviation	mean	Variables	Rank
High	93.2	0.59	4.66	Islamic banks develop a comprehensive strategy on the type and level of risk acceptable to all their activities	1
High	92.4	0.58	4.62	Reports on management compliance with laws, regulations, and standards are reviewed	2
High	89.2	0.63	4.46	Islamic banks are training and training human resources to avoid or reduce risk	3
High	89	0.63	4.45	Risks to risk management are categorized according to their causes	4
High	88.4	0.67	4.42	Islamic banks have a clear policy and appropriate safeguards to reduce loss and mitigate	5

degree	percentage	standard deviation	mean	Variables	Rank
				risk	
<b>High</b>	<b>88.2</b>	<b>0.73</b>	<b>4.41</b>	The bank employee is given clear responsibility for managing and avoiding the risk	<b>6</b>
<b>High</b>	<b>88</b>	<b>0.68</b>	<b>4.40</b>	Islamic banks identify parties that will participate in risk management	<b>7</b>
<b>High</b>	<b>87.6</b>	<b>0.67</b>	<b>4.38</b>	Islamic banks have a permanent record of risks and ways to solve them	<b>8</b>
<b>High</b>	<b>87.2</b>	<b>0.59</b>	<b>4.36</b>	Islamic banks in the risk management approach a clear policy commensurate with the size and privacy of the bank	<b>9</b>
<b>High</b>	<b>88.6</b>	<b>0.44</b>	<b>4.43</b>	Variable as a whole	

## 12. Testing hypotheses

Analysis of variance (ANOVA) has been used in order to know whether the regression models used in the research is significant or not, and the study of the relationship between the factors extracted as independent variables on one hand and strengthening competitiveness as the dependent variable on the other hand when the level of significance is (5% ).

Hypotheses have been statistically tested by using SPSS, using the correlation coefficients between the independent variables and the dependent variable for each hypothesis. They were tested by regression test in order to find correlation coefficients between dependent variables and independent variables to determine whether there is a correlation, and the strength of the relationship between these variables, and then the regression equations were prepared to rely on the F-Test and T-Test to determine the degree of significance of regression equations and significance variables.

### 12.1 Linear correlation test

Table (7) shows that VIF values for all independent variables are less than (5), ranging between (1.63-1.93), while the Tolerance test for all independent variables is greater than (0.05), with a value between 0.52-0.61. Thus, there is no problem of the high correlation between the independent variables, according to the results listed in Table (7) as follows:

**Table (7): Test the coefficient of inflation of variance and allowed variation of the study variables**

(VIF)	(Tolerance)	variable
1.80	0.50	Equity Rules
1.72	0.51	Rules of the Board of Directors
1.81	0.52	Disclosure and transparency rules
1.68	0.63	Rules for ensuring the role of stakeholders
1.96	0.56	Control and control systems
1.93	0.54	Internal Control
1.86	0.58	External Control

### 12.2 Test the first hypothesis:

**H<sub>01</sub>: There is no statistically significant effect of applying the rules of governance to the practice of risk management in Islamic banks.**

The multiple regression equation was applied to verify the validity of the first major hypothesis and to study the effect of applying the rules of governance on risk management in Islamic banks.

Table (8) shows that there is an effect on the extent of applying the rules of governance to risk management in Islamic operating banks. The correlation coefficient (R) (0.81) is a statistically significant correlation between the independent variables combined and the dependent variable. (0.56). this is a statistically significant value that explains the ability to apply the rules of governance to improve the practice of risk management in Islamic banks by 65% of the change in risk management. The value of the test (F) (52) In the ability of independent variables in risk management, thus accepting the main hypothesis in the fixed formula, which is There is a statistically significant effect at the level of significance ( $\alpha$  0.05) to apply the rules of governance to the practice of risk management in Islamic banks with all its independent variable variables.

**Table (8): Results of the multiple regression equation related to the first hypothesis**

Statistical significance	F	R <sup>2</sup>	R	Statistical significance	T	$\beta$	variable
0.00	52	0.56	0.81	0.00	3.00	0.25	Equity Rules
				0.03	2.01	0.18	Rules of the Board of Directors
				0.02	2.4	0.16	Disclosure and transparency rules
				0.00	5.4	0.4	Rules for ensuring the role of stakeholders

### 12.3 Test the second hypothesis

**H<sub>02</sub>: There is no statistically significant effect on the practice of applying the Rule of control and control environment in risk management in Islamic banks.**

Appears from table (9) the correlation coefficient (R) (0.82) was statistically significant and showed a statistically significant correlation between the independent variables combined and the dependent variable. The value of R-square was (0.60). This is a statistically significant value that explains the ability of the control and control environment to improve risk management in Islamic banks. The dimensions of the application of the control and control environment rule account for 65% of the change in risk management. (73) in statistical terms (0.00), which is a statistically significant value at the level of data ( $\alpha \leq 0.05$ ) indicating that there is a variance in the ability of independent variables in risk management, thus accepting the key in the fixed formula, that "there is a statistically significant effect at ( $\alpha \leq 0.05$ ) Islamic banks "and all its sub-variables.

**Table (9): Results of the multiple regression equation related to the second hypothesis**

Statistical significance	F	R <sup>2</sup>	R	Statistical significance	T	$\beta$	variable
0.00	73	0.60	0.82	0.20	-1.10	0.08-	Control and control systems
				0.01	5.4	0.45	Internal Control
				0.00	6.9	0.45	External Control

### 13. Results, conclusions, and recommendations

#### 13.1 Results of the study:

The study reached the following results

- All Islamic banks are the Application of the contents of corporate governance in the practice of risk management.
- The level of application of the contents of corporate governance in the practice of risk management in Islamic banks was generally high

- The application of the property rights protection law affects the practice of risk management in Islamic banks to a high degree
- The application of the Board's Board of Directors rules affects the practice of risk management in Islamic banks to a high degree
- The application of disclosure and transparency rules affects the practice of risk management in Islamic banks to a high degree
- The application of stakeholder role rules affects the practice of risk management in Islamic banks to a high degree
- The level of application of the rules of the environment of control and control in the practice of risk management in Islamic banks was high
- The application of control and control systems to the practice of risk management in Islamic banks is profoundly affected
- The application of internal control affects the practice of risk management in Islamic banks to a high degree
- The application of external control affects the risk management practice of Islamic banks to a high degree

### **13.2 conclusions**

- The application of the contents of corporate governance in Islamic banks helps limit management overruns, increase the harmony between management interests and shareholders' interests, and reduce investment and financial risks.
- The existence of bilateral governance resulting from the existence of two different boards - the Board of Directors in the control of the administrative side of the Bank and the Shari'ah Supervisory Board in monitoring the compatibility of banking operations with Islamic Shari'ah - enhances risk control in these banks.
- Governance helps to increase the achievement of managers and employees, identify and evaluate risks, measure and develop strategies for managing them, and take appropriate action to minimize their adverse impacts.
- Raising awareness of the importance of governance and Shari'ah supervision as an essential component of the Bank's culture.

### **13.3 recommendations**

In light of the results of the study, the researcher reached several recommendations:



- Providing guidelines for bank governance rules that are paper and computerized to help employees and stakeholders to access and activate them.
- The existence of Islamic accounting standards and rules of governance derived from Islamic thought and based on scientific and jurisprudential consolidation lead to the unification of controls and principles governing the commercial and banking relations between enterprises and individuals, the government, the judiciary and regulatory bodies and stakeholders, which makes the transparency of banking and increase confidence.
- To select a sufficient number of qualified and trained human cadres and appoint them under requirements of rules of governance in its departments because of the impact on its performance.
- Preparation of training programs to develop the skills of employees in Islamic banks.

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