Advanced International Journal of Business, Entrepreneurship and SME's
EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018


ADVANCED INTERNATIONAL JOURNAL OF BUSINESS, ENTREPRENEURSHIP AND SMES (AIJBES)
www.aijbes.com

# THE EFFECT OF BANK-SPECIFIC FACTORS ON ISLAMIC BANKS' STABILITY

Md. Mahbub Alam[1]*, Wan Sallha Yusoff [2], Dayang Hasliza Muhd Yusuf[3], Mohd Rosli Abdul Ghani[4], Raziff Jamaluddin[5], Nur Syuhadah Kamaruddin[6], Arif Ahsan[7]

[1] Faculty of Business & Communication, Universiti Malaysia Perlis, Padang Besar 02100, Perlis, Malaysia
Email: mahbub.amu@gmail.com
[2] Faculty of Business & Communication, Universiti Malaysia Perlis, Padang Besar 02100, Perlis, Malaysia
Email: wansallha@unimap.edu.my
[3] Centre of Excellence for Social Innovation & Sustainability (CoESIS); Faculty of Business & Communication, Universiti Malaysia Perlis, Padang Besar 02100, Perlis, Malaysia
Email: dayanghasliza@unimap.edu.my
[4] Centre of Excellence for Social Innovation & Sustainability (CoESIS); Faculty of Business & Communication, Universiti Malaysia Perlis, Padang Besar 02100, Perlis, Malaysia
Email: mohdrosli@unimap.edu.my
[5] Faculty of Business & Communication, Universiti Malaysia Perlis, Padang Besar 02100, Perlis, Malaysia
Email: raziff@unimap.edu.my
[6] Faculty of Business & Communication, Universiti Malaysia Perlis, Padang Besar 02100, Perlis, Malaysia
Email: Syuhadah@unimap.edu.my
[7] Faculty of Business & Communication, Universiti Malaysia Perlis, Padang Besar 02100, Perlis, Malaysia
Email: arifahsan@studentmail.unimap.edu.my
* Corresponding Author

**Article Info:**

**Article history:**
Received date: 30.06.2025
Revised date: 29.07.2025
Accepted date: 20.08.2025
Published date: 01.09.2025

**To cite this document:**

Alam, M. M., Yusoff, W. S., Yusuf, D. H. M., Abdul Ghani, M. R. A., Jamaluddin, R., Kamaruddin, N. S., & Ahsan, A. (2025). The Effect Of Bank-Specific Factors On Islamic Banks' Stability. *Advanced International Journal of Business*

**Abstract:**

The inconsistency in Islamic banking stability in Bangladesh is due to several challenges, including bank-specific factors. This study investigates the impact of bank-specific factors on the stability of Islamic banks in Bangladesh from 2012 to 2023. By analyzing key financial ratios and indicators, the research identifies critical determinants of stability in the context of Islamic banking. The study employs a panel dataset from seven Islamic banks, utilizing Feasible Generalized Least Squares (FGLS) to address cross-sectional dependence and heteroscedasticity. Key findings reveal that asset quality is the most significant factor influencing bank stability, highlighting the importance of maintaining a strong loan portfolio. Income diversification also plays a crucial role in mitigating risks by reducing reliance on a single source of income. Conversely, poor managerial efficiency and liquidity risk were found to have a negative impact on stability. While capital adequacy is typically associated with stability, the study suggests that excessively high capital reserves may lead to inefficiencies, reducing overall stability. Interestingly, the study finds that Sharia-compliant contracts (ISCON) do not significantly impact stability.

Advanced International Journal of Business, Entrepreneurship and SME's
EISSN: 2682-8545
AIJBES
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018

*Entrepreneurship and SMEs, 7* (25), 272-285.

**DOI:** 10.35631/AIJBES.725018



These findings reaffirm the multi-dimensional character of bank stability, with efficient management, superior asset quality, diversification of income structure, and wise liquidity strategy being key. The study has identified valuable areas that can enhance the resilience of Islamic banks, focusing on specific areas that will yield future regulatory and operational benefits in the industry.

**Keywords:**

Bank Stability, Capital Adequacy, Income Diversification, Islamic Banks, Liquidity Risk, Managerial Efficiency

## Introduction

The global financial crisis of 2007-2008 revealed severe weakness in conventional banking, leaving experts to wonder how Islamic banks would have fared in the same storm (Khan et al., 2018). Because Islamic finance banks base their operations on risk-sharing, asset-backed lending, and an outright ban on speculation, analysts expect their framework to provide cushioning for firms against sudden market shocks. Studies show that during turbulence, Islamic lenders typically outperform their conventional rivals, partly because they avoid derivatives and excessive leverage, instead anchoring every product to a tangible asset (Iqbal et al., 2024; Raouf & Ahmed, 2020). Still, profitability and resilience are never determined by faith alone; bank-specific policies, sector-wide conditions, and overarching macro signals all shape how and why a given institution succeeds or stumbles (Badwan et al., 2024; Serly & Handayani, 2020). In Bangladesh, this dynamic has translated into steady expansion, with Sharia-compliant banks now accounting for nearly half of the nation's total banking assets and steadily expanding their customer base (Joudar et al., 2023; Alaeddin et al., 2019). Due to the unique features of Islamic banking, it is crucial to examine its stability in Bangladesh. Research has found that capital adequacy, asset quality, management efficiency, and earnings metrics are all bank-specific factors that significantly impact stability (Alam et al., 2024; Muhiuddin & Jahan, 2018).

Stability in Islamic banking hinges on the effective allocation of capital, prudent risk management, and the sustained generation of profits (Setiawan, 2018). However, sound operation is not only a technical exercise; confidence from customers and investors, continual depositor loyalty, and a constructive role in national growth together reinforce that stability (Rahman, 2019; Nugraheni & Muhammad, 2019). Because these banks operate according to Shari'a principles and rely on profit-and-loss sharing, understanding institution-specific assets, liabilities, governance practices, and liquidity sources becomes crucial (Bakar & Sole, 2020). For supervisors, knowledge of such determinants enables regulators to craft proportionate oversight rules, calibrate capital buffers, and develop stress-test scenarios that respond to the unique risk constellation they face (Ahmed et al., 2019). Managers, for their part, benefit from aligning their funding mix, investment policy, and risk appetite with data-driven benchmarks, enabling strategic moves that build resilience and support long-term shareholder and stakeholder value (Hossain & Imam, 2018).

The banking system is a crucial element in the economic growth of any nation, and China's rise as an economic superpower is primarily attributed to the well-established foundation of its banking system (Zhengmeng et al., 2022). Islamic banking has emerged as a significant force in the global financial market, providing Shariah-compliant financial services. The Islamic

Advanced International Journal of Business, Entrepreneurship and SME's
AIJBES
EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018
banking model prohibits interest collection and encourages risk-sharing, as well as ethical and social responsibility (Alam & Yusuf, 2024; Omri, M.B., 2022). The rise of Islamic banks has been very swift over the past few decades, especially in the Muslim states and those areas, or the so-called regions, that exhibit a high Muslim population. Islamic banking in Bangladesh is thriving and expanding, with other Islamic banks coexisting alongside conventional banks (Nabi et al., 2023). The banking system of Bangladesh is regulated by its central bank, the Bangladesh Bank, which also regulates Islamic banks (Rahman et al., 2024). Recently, the Islamic banking sector in Bangladesh has experienced a period of rapid growth, largely driven by a gradually increasing demand for Shariah-compliant financial products and services (Khan et al., 2020; Mabkhot & Al-Wesabi, 2022).

The stability of Islamic banks in Bangladesh is crucial due to their growing role in the country's financial system and the unique risks associated with Islamic banking practices, such as profit-loss sharing and ethical investment restrictions (Sarker, 2018). Despite this importance, limited research exists on the factors influencing their stability, particularly in the context of Bangladesh's volatile economy and regulatory challenges (Alam & Yusuf, 2024; Dutta & Saha, 2021; Rahman et. al, 2018). Previous studies on bank stability in Bangladesh have primarily focused on conventional banks, with limited research on Islamic banks (Sarker, 2018; Habib, 2021). Much of the existing literature on bank stability in Bangladesh has focused on the impact of macroeconomic factors, with less attention paid to bank-specific factors (Alam & Yusuf, 2024; Samad, 2015). Additionally, there is a need for more research on the specific challenges and opportunities facing Islamic banks in Bangladesh, given their unique operating environment and regulatory framework. This study aims to investigate the effect of bank-specific factors on the stability of Islamic banks in Bangladesh from 2012 to 2013. By analyzing a range of financial ratios and indicators, the study seeks to identify the key determinants of bank stability in the context of Islamic banking in Bangladesh.

**Literature Review**

A prior study indicates that several bank-specific attributes, such as capital adequacy, asset quality, managerial efficiency, and income diversification, significantly influence the financial stability of Islamic banks in Bangladesh. The Z-score is commonly used to assess stability, and the findings indicate that Islamic banks frequently exhibit greater resilience than conventional banks (Danlami et al., 2022). Banking stability is a broad term that describes a bank's ability to withstand economic shocks, maintain solvency, and continue serving customers without major disruptions (Kasri & Azzahra, 2020). When banks are stable, public confidence is sustained, long-term growth is supported, and the risk of widespread financial panic is significantly reduced. A resilient banking system allocates capital more efficiently, monitors and mitigates risk exposure, and meets the daily credit and payment needs of households and firms (Bilgin et al., 2021; Alam et al., 2018). Analysts typically assess stability through four key pillars: capital adequacy ratios, asset quality, profitability or earnings performance, and liquidity measures. Nevertheless, these indicators do not operate in isolation; they reflect complex interactions among individual bank traits, sector-wide dynamics, macroeconomic shocks, and the design of supervisory rules (Alihodžić et al., 2020). On the micro level, a stable bank usually shows solid capital buffers, low default rates on loans, prudent management practices, and consistent income generation.

The capital adequacy ratio (CAR) remains the primary yardstick used to assess the health of an Islamic bank. A high CAR indicates to outside observers that the bank has sufficient capital on hand to absorb losses and maintain operations until the usual funding sources reopen. Evidence

Advanced International Journal of Business, Entrepreneurship and SME's
AIJBES
EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018

from Bangladesh increasingly supports this view, showing that lenders with thicker capital cushions tend to weather macroeconomic shocks with fewer disruptions (Anjom, 2023; Gazi et al., 2024). Regulators view CAR as a safety filter, yet it also overlaps with profitability, as well-capitalized banks typically allocate each dinar of capital with disciplined risk awareness (Kalifa & Bektas, 2018). Still, scholars warn that the link is not always a straight line; when CAR climbs too high, it can trap funds in underutilised equity, dragging down both the return on assets and the return on equity (Gazi et al., 2024; Harkati et al., 2020). For that reason, boardrooms and supervisors should set CAR targets that boost resilience while steering clear of wasteful over-capitalization (El-Ansary et al, 2019).

Loan loss provisions (LLPs) are crucial for Islamic banks because they indicate the institution's effectiveness in protecting itself against troubled assets (Islam, 2018). When LLPs are set at an appropriate level, analysts often interpret this as strong risk oversight and link it to generally improved financial outcomes; yet, excessive provisioning can still sap overall profits and reduce funds available for shareholders (Saha, 2024). Evidence from Bangladesh suggests that LLPs tend to enhance performance on their own, and the effect is more potent when they are combined with other safeguards, such as maintaining adequate capital and managing liquidity tightly (Saha, 2024; Tasnova, 2022), indicating that a careful balance in provisioning is crucial. Bangladeshi Islamic banks need to manage their operating costs to remain profitable and financially stable. This profit-focused approach to minimising costs is critical in maintaining customer trust and minimising business risk (Ahsan, 2018a; Güngör, 2023). Larger banks have cost-saving technological advantages that can help streamline operations, while smaller banks face challenges due to limited economies of scale (Haque & Sohel, 2019). Operating costs that are too high can significantly reduce profitability by eroding profit margins (Ahsan, 2018b; Güngör, 2023). Regarding the stability of Islamic banks, liquidity risk is also a significant concern. The higher the liquidity ratios, the better the performance concerning the periods of financial distress (Anjom, 2023; Tasnova, 2022). The lack of liquid funds poses a significant risk due to the high probability of creating a serious financial crisis (Anjom, 2023; Tasnova, 2022). Banks in Bangladesh are characterised by excess liquidity, which leads to inefficiencies within the banking system. The correct ratio of excess and insufficient liquidity is closely tied to optimising asset utilisation and ensuring smooth operations (El Khatib, A.S., 2024; Islam et al., 2019).

Income diversification is essential for the stability of Islamic banks, as it reduces their dependence on a single income source. The use of non-interest income sources, including fees and commissions, has the potential to help the bank operate more effectively during periods of economic decline (Uddin et al., 2021; Fakhrunnas et al., 2024). As the banking market in Bangladesh becomes increasingly competitive, it is evident that Islamic banks offering Shariah-compliant products are experiencing more sustainable growth and stability (Uddin et al., 2021; Gnungor, 2023). Additionally, another critical measure of a bank's profitability and stability is its Return on Equity (ROE). Banks with increased returns on equity tend to perform better and are better cushioned against financial shocks (Pessarossi et al., 2020; Gazi et al., 2024; Rumaly, 2023). Nevertheless, macroeconomic trends, such as inflation and fluctuations in interest rates, will most likely raise expenditures and decrease profitability, thereby adversely affecting the ROE (Saha et al., 2024; Rumaly, 2023; Noman et al., 2015). Therefore, it is possible to conclude that Islamic banks in Bangladesh need to balance their equity and profit so that the Return on Equity (ROE) is not aggressive (Jigeer & Koroleva, 2023; Haque & Farzana, 2018).

Advanced International Journal of Business, Entrepreneurship and SME's
AIJBES
EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018

Islamic Contracts (ISCON) is crucial for the stability of Islamic banks, as it provides sound Sharia governance, which enhances asset quality and promotes more conservative lending practices (Grice & Strahan, 2022). It also supports diversification of income through Sharia-compliant revenue streams (Rousseau, 2022). Proper management, grounded in ISCON principles, enables banks to align their financial strategies with Shariah guidelines while enhancing performance (Rousseau, 2022). Research indicates that different Islamic financing contracts, such as Murabahah and Bai Bithaman Ajil, affect stability in varying ways. Most Islamic banks utilise the Murabahah and Bai Bithaman Ajil contracts to enhance long-term stability (Waemustafa & Sukri, 2015; Fakhrunnas & Bekti, 2023). Additionally, factors such as liquidity risk and the size of Sharia boards influence stability differently across regions (Fakhrunnas & Bekti, 2023). While the relationship between ISCON and bank stability is not always negative, it varies based on the type of contract and governance practices involved. The following Table 1 summarizes the key findings on the impact of individual bank-specific factors on Islamic banks' stability in Bangladesh:

**Table 1: Key Findings on The Impact of Individual Bank-Specific Factors on Islamic Banks' Stability**

| Factor | Impact on Stability | Citation |
|---|---|---|
| Capital Adequacy Ratio | Positive impact on Islamic banks' stability | (Anjom, 2023; Gazi et al., 2024; Kalifa & Bektas, 2018) |
| Loan Loss Provision | Positive impact on Islamic bank stability by managing credit risk and absorbing potential losses | (Saha, 2024; Durguti, 2020; Velliscig et al., 2022) |
| Managerial Efficiency | Negative impact on Islamic banks' profitability and stability due to higher operational costs | (Güngör, 2023; Albaity et al., 2019; Haque &Sohel, 2019) |
| Income Diversification | Positive impact on stability by reducing reliance on a single income source | (Adem, 2022; Güngör, 2023; Uddin et al., 2021) |
| Return on Equity (ROE) | Positive impact on Islamic banks profitability and stability by generating substantial profits from equity | (Rumaly, 2023; Jigeer & Koroleva, 2023; Noman et. al, 2015; Pessarossi et al., 2020) |
| Liquidity Risk | Negative impact on stability by increasing the risk of financial distress | (Tasnova, 2022; Islam et al., 2019; Ahmad, F., 2021.) |
| ISCON | Negative effect on Islamic banks' stability | (Fakhrunnas & Bekti, 2023; Waemustafa & Sukri, 2015) |

## Methodology and Model

This study utilizes a panel dataset comprising seven full-fledged Islamic banks out of ten in Bangladesh, spanning the period from 2013 to 2023. Data was collected from secondary sources, including annual reports, Fitch Solutions, and Bloomberg. The FGLS (Feasible Generalized Least Squares) method is employed in this study to address potential issues of cross-sectional dependence and heteroscedasticity in the panel dataset, as presented in Appendix 1. These issues can arise when the residuals (errors) from the model are correlated across different units (in this case, banks) or when the variance of the residuals differs across observations. By using FGLS, the study corrects for these problems, leading to more efficient and reliable parameter estimates. This helps validate whether the main effects are held under different estimation assumptions, thereby increasing the credibility of the findings. The econometric models are as follows:

Advanced International Journal of Business, Entrepreneurship and SME's
AIJBES
EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018

$$Z\text{-}score_{it} = \beta_0 + \beta_1\ CAPITAL_{it} + \beta_2\ ASSQ_{it} + \beta_3\ ME_{it} + \beta_4\ INDIV_{it} + \beta_5\ LR_{it} + \beta_6\ ROE_{it} + \beta_7\ ISCON_{it} + \varepsilon_{it}$$

Where Z-score = Bank stability, independent variables include Capital Adequacy Ratio (CAR), Asset Quality (ASSQ), Managerial Efficiency (ME), Income Diversification (INDIV), Liquidity Risk (LR), Profitability (ROE), and Islamic Contracts (ISCON)

***Variable Measurement***

Table 2 describes the selected variables for this study, which will be used to measure Z-scores and the independent variables

**Table 2: Description of Variables Used in Empirical Models**

| Variables | Measurement/Description | Acronyms |
|---|---|---|
| **Dependent Variables** | | |
| Z-score | EA+ROA/σ(ROA). EA represents the ratio of equity to bank assets, while σ(ROA) indicates the volatility of the bank's return on assets | Z-score |
| **Independent Variables** | | |
| Capital Adequacy | (Tier 1 capital and Tier 2 capital) to Risk-Weighted Assets | CAPITAL |
| Asset Quality | Loan loss reserve to Total loan. | ASSQ |
| Managerial Efficiency | Total operation expense to operating income | ME |
| Income Diversification | 1- (net interest income- other operating income)/total operating income | INDIV |
| Liquidity risk | Liquid asset to Total asset | LR |
| Profitability (ROE) | Net income to total equity | ROE |
| ISCON | Financing by Shariah concept (Bai murabaha+bai Bithaman Ajil) to total finance | ISCON |

**Results**

The descriptive analysis of Islamic banks in Bangladesh, as provided, presents a summary of key financial and operational metrics. The data includes 77 observations, with variables such as capital adequacy ratio (CAPITAL), asset quality (ASSQ), managerial efficiency (ME), income diversification (INDIV), liquidity risk (LR), return on equity (ROE), and Islamic contracts (ISCON). Table 3 shows that the capital adequacy ratio (CAPITAL) has a mean of 0.126, indicating moderate capital strength with slight variability across the banks. Asset quality (ASSQ) averages 0.027, suggesting low variability in asset quality. Managerial efficiency (ME) shows a mean of 0.579, reflecting significant differences in management effectiveness among the banks. Income diversification (INDIV) has an average of 0.354, indicating moderate diversification within the sector. Liquidity risk (LR) is relatively stable, with a mean of 0.12, while return on equity (ROE) averages 0.119, signaling moderate profitability. Finally, Islamic contracts (ISCON) have a mean of 0.624, indicating strong performance in offering Islamic financial products. Overall, while the banks show stability in most areas, there is variability, particularly in managerial efficiency and profitability.

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AIJBES
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DOI 10.35631/AIJBES.725018

**Table 3: Descriptive analysis**

| Variable | Obs | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|---|
| Z-score | 77 | 3.654 | 1.25 | -2.605 | 5.083 |
| CAPITAL | 77 | 0.126 | 0.016 | 0.091 | 0.167 |
| ASSQ | 77 | 0.027 | 0.008 | 0.015 | 0.047 |
| ME | 77 | 0.579 | 0.213 | 0.149 | 0.99 |
| INDIV | 77 | 0.354 | 0.108 | 0.155 | 0.664 |
| LR | 77 | 0.12 | 0.042 | 0.045 | 0.23 |
| ROE | 77 | 0.119 | 0.033 | 0.047 | 0.202 |
| ISCON | 77 | 0.624 | 0.131 | 0.341 | 0.905 |

Table 4 shows the correlation analysis of Islamic banks in Bangladesh reveals several key relationships. The Z-score, indicating stability, shows weak negative correlations with capital adequacy (-0.056), liquidity risk (-0.240), and return on equity (-0.210), while a weak positive correlation with asset quality (0.248). Managerial efficiency exhibits a moderate negative correlation with the Z-score (-0.358), suggesting that poor management is linked to higher risk. Income diversification shows a weak positive correlation with the Z-score (0.187), with negligible correlation from Islamic contracts (-0.028). Notably, asset quality has a strong negative correlation with profitability (-0.535), and managerial efficiency is negatively correlated with liquidity risk (-0.361). Overall, the analysis highlights complex interrelationships, particularly showing that poorer managerial efficiency, asset quality, and liquidity risk can negatively impact stability and profitability in Islamic banks in Bangladesh.

**Table 4: Matrix of Correlations**

| Variables | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
|---|---|---|---|---|---|---|---|---|
| Z-score | 1.000 | | | | | | | |
| CAPITAL | -0.056 | 1.000 | | | | | | |
| ASSQ | 0.248 | 0.095 | 1.000 | | | | | |
| ME | -0.358 | -0.352 | 0.007 | 1.000 | | | | |
| INDIV | 0.187 | 0.069 | 0.137 | -0.056 | 1.000 | | | |
| LR | -0.240 | -0.361 | -0.386 | 0.277 | 0.126 | 1.000 | | |
| ROE | -0.210 | -0.160 | -0.535 | 0.037 | -0.187 | 0.440 | 1.000 | |
| ISCON | -0.028 | -0.130 | 0.008 | -0.076 | -0.462 | 0.052 | 0.151 | 1.000 |

Table 5 shows the results of the FGLS linear regression of the model. In this table, Asset quality (ASSQ) emerges as the most significant factor contributing to bank stability, with a highly significant positive coefficient (81.063, p-value = 0.000). This makes sense because high asset quality directly reflects the bank's ability to withstand economic shocks and financial downturns, ensuring that its loan portfolio is well-managed and less risky. Strong asset quality reduces the likelihood of defaults, thereby enhancing the bank's financial stability (Saha, 2024). In contrast, Managerial efficiency (ME) has a negative impact on stability (coefficient = -2.105, p-value = 0.001). This suggests that inefficiencies in management practices, such as poor decision-making, inadequate resource allocation, or a lack of strategic direction, undermine the bank's ability to adapt to market changes, which consequently leads to reduced stability (Güngör, 2023; Haque &Sohel, 2019). In contrast, well-managed banks can better navigate economic fluctuations, regulatory changes, and competitive pressures.

Advanced International Journal of Business, Entrepreneurship and SME's
AIJBES
EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
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Income diversification (INDIV) is another crucial positive contributor to stability (coefficient = 3.897, p-value = 0.000). Banks that diversify their revenue streams are less vulnerable to the volatility of a single source of income. In the case of Islamic banks, diversified income streams across various financial products, including non-interest-based sources, help mitigate risks associated with market changes, thereby strengthening stability (Uddin et al., 2021; Güngör, 2023).

The negative relationship between liquidity risk (LR) and bank stability (coefficient = -6.883, p-value = 0.013) is intuitive. Banks with high liquidity risk may struggle to meet short-term obligations, which could undermine their solvency and overall stability. Liquidity issues often signal deeper financial weaknesses and increase the likelihood of bank runs or insolvency, especially in times of economic stress (Tasnova, 2022; Islam et al., 2019). Interestingly, the capital adequacy ratio (CAPITAL) shows a negative but marginally significant effect (coefficient = -11.654, p-value = 0.099). While capital is typically viewed as a buffer against financial instability, the negative relationship in this context suggests that excessively high capital reserves may indicate inefficiency in utilising available resources to generate returns. The negative coefficient suggests that higher capital adequacy may reduce stability, potentially due to **inefficient capital deployment** or **unique risk structures** inherent in Islamic banking, such as profit-and-loss sharing and asset-backed financing (Gazi et al., 2024; Harkati et. al., 2020). Islamic banks regulatory requirements on capital adequacy need to aim to ensure stability; they might inadvertently limit the ability of Islamic banks to take on profitable but riskier investments.

Finally, return on equity shows a positive but marginally significant effect (p-value of 0.085). Although higher profitability generally enhances stability, its impact is less pronounced compared to factors like asset quality and income diversification (Rumaly, 2023). On the other hand, ISCON's impacts on the stability of banks is almost negligible, demonstrated by the p-value of 0.283. The negative coefficient of -1.669 suggests that there is no considerable or meaningful impact either. Even though Islamic banks in Bangladesh function under certain Sharia-compliant contracts, such contracts do not appear to impact model stability. This suggests that other internal and external elements, like asset quality and liquidity management, are more important than Islamic contract considerations. In summary, the data suggests that Islamic finance principles are less important than other operational and financial considerations in determining bank stability. All the results together illustrate that there is a broader framework at play in the context of banking stability, where sound management, good asset quality, diversified revenue streams, and liquidity control take precedence, complemented by effective sharia governance. The interdependence and interplay of these Islamic banking fundamentals should be a major takeaway for Islamic banks looking to build their resilience and sustainability over time.

**Table 5: Linear Regression, Feasible Generalized Least Squares (FGLS)**

| Z-score | Coef. | Std. Err. | t-value | p-value | [95% Conf | Interval] | Sig |
|---|---|---|---|---|---|---|---|
| CAPITAL | -11.654 | 7.065 | -1.65 | 0.099 | -25.501 | 2.193 | * |
| ASSQ | 81.063 | 18.865 | 4.30 | 0.000 | 44.088 | 118.037 | *** |
| ME | -2.105 | .638 | -3.30 | 0.001 | -3.355 | -.855 | *** |
| INDIV | 3.897 | 1.083 | 3.60 | 0.000 | 1.774 | 6.02 | *** |
| LR | -6.883 | 2.776 | -2.48 | 0.013 | -12.324 | -1.441 | ** |
| ROE | 7.186 | 4.167 | 1.72 | 0.085 | -.981 | 15.354 | * |

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EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| ISCON | -1.669 | 1.554 | -1.07 | 0.283 | -4.716 | 1.377 | |
| Constant | 3.62 | 1.784 | 2.03 | 0.042 | .124 | 7.116 | ** |
| | | | | | | | |
| Mean dependent var | | 3.654 | | SD dependent var | | 1.250 | |
| Number of obs | | 77 | | Chi-square | | 83.568 | |

**Conclusion**

The study results show that various bank-specific factors contribute to the stability of Islamic banks in Bangladesh. The most important factors of bank stability, as found in the current study, are asset quality, management efficiency, income diversification, liquidity risk, and capital adequacy. The asset quality was found to be the most significant factor impacting stability, emphasizing the importance of maintaining a well-maintained and high-quality loan portfolio. Diversification of income was also found to be significant in ensuring stability, as it enables banks to avoid focusing on a single source of income while generating income, especially during risky occurrences. On the other hand, low managerial efficiency and liquidity risk were also identified as possible weak factors in the stability of Islamic banks, so banks need to improve their operational practices and effective liquidity management. Interestingly, although capital adequacy is typically considered stabilizing, the study's results suggest that excessively high capital reserves may lead to inefficiency, which in turn reduces stability in the case of Islamic banks.

The research also indicates that Sharia-compliant contracts (ISCON) have no significant direct impact on bank stability, and therefore, other factors, such as financial and operational imperatives, may be stronger direct determinants of bank stability. As a whole, these results underscore the importance of adopting a moderate approach to capital, assets, sources of income, and liquidity, which will enable the strengthening of Islamic banks in Bangladesh and globally. Future studies may also examine in more detail how external factors, including regulatory systems and macroeconomic variables, affect Islamic bank stability.

***Implication***

Such a study also has various implications for policymakers, bank managers, and stakeholders in the Islamic banking sector. Initially, it is imperative to ensure the maintenance of asset quality management and the balancing of capital adequacy requirements to prevent inefficiencies within Islamic banks. A critical step involves establishing a comprehensive regulatory framework to effectively oversee the loan portfolio and non-performing assets, thereby fostering financial stability. Additionally, bank managers should prioritise operational optimisation and the mitigation of liquidity risks. Strategic decision-making in these areas can facilitate resource acquisition, liquidity management, and other essential processes that mitigate risks and promote stability, particularly during economic downturns. Furthermore, diversification of income streams should be recognised as a vital strategy to reduce reliance on a single revenue source, enhancing resilience against market fluctuations. Although Sharia-compliant contracts do not directly impact stability, it remains essential for banks to implement robust Sharia governance to ensure operations adhere to ethical standards, thus supporting operational efficiency. Lastly, future research should consider that the stability of Islamic banks is influenced by macroeconomic factors and regulatory environments, which help explain tendencies toward instability driven by external influences. In summary, the recommendations suggest that Islamic banks should adopt a balanced approach to asset quality management, liquidity control, income diversification, and the implementation of processes designed to strengthen solvency and ensure sustainable stability amid a dynamic financial landscape.

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DOI 10.35631/AIJBES.725018

**Acknowledgement**

The authors express gratitude to their universities for providing the necessary resources and academic environment to conduct this research. I extend my gratitude to colleagues and peers whose constructive feedback enhanced the examination of Islamic banking stability in Bangladesh. We sincerely thank the Ministry of Higher Education for their support through the Fundamental Research Grant Scheme (FRGS), Reference Code: FRGS/1/2024/SS01/UNIMAP/02/2. We also extend our gratitude to Universiti Malaysia Perlis (UniMAP) for their administrative and institutional support, and to our co-authors for their invaluable contributions and collaboration throughout this research.

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AIJBES
EISSN: 2682-8545
Volume 7 Issue 25 (September 2025) PP. 272-285
DOI 10.35631/AIJBES.725018

**Appendix 1**

| **Test Statistic** | **P-value** | **H0:no Dependency** |
|---|---|---|
| -2.107 | 0.0351 | Dependency Exist |
| **F-Test** | **Prob> *F*** | **H0: no first-order autocorrelation** |
| (1, 6) = 7.929 | 0.0305 | Autocorrelation Exist |
| **Chi-Square** | **Prob> *X2*** | **H0:no heteroskedasticity** |
| 32.99 | 0.0000 | Heteroskedasticity Exist |