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The Influence of Financial Performance and Economic Performance on the Financial Stability of ASEAN Islamic Banking

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Abstract

Global dynamics and geopolitical uncertainty put pressure on the stability of the financial system, including Islamic banking. Fluctuations in Islamic financial and economic performance tend to be unstable, potentially hampering real sector growth and reducing the competitiveness of the Islamic economy globally. This research uses a quantitative approach with a panel data regression method, which combines time series and cross-sectional data. The variables used include financial performance indicators, namely ROE, ROA, CAR, and NPF, as well as economic performance indicators, including GDP growth, inflation, and the unemployment rate. These findings indicate that certain macroeconomic variables and profitability levels play a role in maintaining the stability of the Islamic banking system. The implications of this research emphasize the importance of incorporating labor market indicators into macroprudential policies, the need for a different approach in handling interbank crises, and the acceleration of digitalization due to the pandemic, which presents both opportunities and risks for financial stability.

INTRODUCTION

The International Bank for Reconstruction and Development (IBRD) states that financial stability is crucial for economic growth, as most transactions in the real economy are conducted through the financial system. Financial system stability is a crucial foundation for sustainable economic growth. The International Monetary Fund (IMF) noted that in 2020, global economic growth contracted by -3.1%, and most developing countries in Southeast Asia were significantly impacted (Rohimah, 2024). This condition emphasizes the need for resilience in the financial sector to maintain stability. Islamic banking, as one of the rapidly growing financial subsectors in ASEAN, faces significant challenges due to rising global interest rates. Although not interest-based in principle, Islamic banks remain indirectly exposed through market mechanisms, funding costs, exchange rates, and customer preferences. Ismail and Farid (2023).

However, global interest rate dynamics continue to have an indirect impact on its operations through market mechanisms, financial risks, and customer preferences (Ismail and Indrawati, 2020). This raises questions regarding the financial stability of Islamic banking amid external pressures (Hassan, 2023). Islamic banking in the ASEAN region has experienced rapid growth in the past two decades. Data from the Islamic Financial Services Board (IFSB, 2023) shows that the global Islamic financial market share has reached over USD 3 trillion, with significant contributions from Indonesia and Malaysia as two major centers of Islamic finance. However, global dynamics such as the 2008 financial crisis, the Covid-19 pandemic, global inflation, and geopolitical uncertainty put pressure on the stability of the financial system,

including Islamic banking.

The main problem arises from the close relationship between financial stability and internal bank performance (profitability, asset quality, capital, liquidity) and external macroeconomic conditions (economic growth, inflation, unemployment). Instability in any of these factors can trigger vulnerabilities in Islamic banking, potentially spreading to the regional financial system.

If these issues are not addressed, the stability of ASEAN Islamic finance will be threatened, ultimately eroding public trust, slowing real sector growth, and weakening the global competitiveness of the Islamic economy. Several previous studies have examined this issue, for example, Ajizah & Widarjono (2023) who examined the stability of Indonesian Islamic banking during the pandemic, and Kurniawan et al. (2023) who compared the performance of Islamic banks in Indonesia and Malaysia. However, most studies focus on a single country, or compare Islamic banks with conventional banks, resulting in few studies examining the stability of Islamic banking across ASEAN countries.

Thus, the identification of the main problems of this research is:

a) The stability of ASEAN Islamic banking still faces risks from both internal (financial performance) and external (economic performance) aspects.
b) There is still limited empirical research across ASEAN countries regarding the factors that influence the financial stability of Islamic banking.
c) There is a need to understand the dominant factors between financial performance and economic performance that most influence the financial stability of Islamic banking.

By formulating this problem, this study aims to answer crucial and in-depth questions regarding the dynamics occurring in the Islamic banking sector in ASEAN. It is hoped that the results of this study will provide broader insights into the interaction between global monetary policy and Islamic banking stability, as well as provide useful recommendations for policymakers and practitioners in enhancing the resilience of the Islamic banking sector amidst constantly changing global economic conditions.

From the various reviews above, this study seeks to provide a broader contribution by comprehensively analyzing how the influence of financial performance and economic performance can affect the financial stability of Islamic banking other than Indonesia with the title "The Influence of Financial Performance and Economic Performance on the Financial Stability of ASEAN Islamic Banking".

After identifying various problems, this research was narrowed down to be more focused. Specifically, the research object is focused on Islamic banking in the ASEAN region (Indonesia and Malaysia). The independent variables studied are internal financial performance such as CAR, NPF, ROA, FDR and macroeconomic financial performance of inflation and GDP growth. The dependent variable is the financial stability of Islamic banking as measured by the Z-Score. The research period is limited to 2019–2024. This research focuses on quantitative analysis with a panel regression approach with statistical software such as Eviews.

This research is expected to enrich the academic literature on the stability of Islamic banking, especially in the cross-ASEAN context, namely as follows:

d) Strengthening the study of the relationship between bank financial performance and macroeconomic performance on Islamic financial stability.
e) Provides new empirical evidence in testing the stability indicator (Z-score) in the ASEAN

Islamic banking context.

f) Filling the gap in previous research which focused more on conventional banks or single country studies.

METHODS

This study used a quantitative approach to data analysis using panel data regression. This method was chosen based on the nature of the research data, which consists of a combination of time series (2019–2023) and cross-sectional data (Indonesia, Malaysia, Brunei Darussalam, and Thailand). Panel data analysis was chosen because it better captures the dynamics of differences between countries and variations over time, resulting in more robust research results.

This study uses secondary data obtained from the annual financial reports of Islamic banks officially published on the websites of the banks or financial regulators of their respective countries. This study was conducted during the period 2025, using Islamic bank financial data from the last five years (2019-2023). The operational definition of the variables in this study consists of independent variables (financial performance and economic performance) and dependent variables (financial stability of ASEAN Islamic banking). The type of data used in this study is quantitative data, because the study focuses on testing the causal relationship between financial performance, economic performance, and financial stability of Islamic banking in the ASEAN region.

Islamic bank financial data such as Return on Assets (ROA), Return on Equity (ROE), Capital Adequacy Ratio (CAR), Non-Performing Financing (NPF), and Financing to Deposit Ratio (FDR) will be obtained from annual financial reports, bank annual reports, and official publications of the Financial Services Authority (OJK), Bank Negara Malaysia, Brunei Darussalam Monetary Authority, and central banks of other ASEAN countries.

Meanwhile, economic performance indicators such as Gross Domestic Product (GDP), inflation, and benchmark interest rates will be obtained from official publications of international institutions such as the World Bank, the International Monetary Fund (IMF), and the Asian Development Bank (ADB), as well as from the national statistical institutions of each ASEAN country. Data on the financial stability of Islamic banking will be calculated using formulas such as the Z-score, profitability volatility, or other stability ratios based on Islamic bank financial report data.

This secondary data collection was conducted because the research is macro-analytical and requires historical data over a long period (2019–2023). Secondary data is also considered more efficient and reliable because it comes from credible official institutions. Therefore, the data used

in this study is academically sound and provides a strong empirical basis for further analysis. The Z-score formula is as follows:

There are several stages of analysis, the first of which is the Classical Assumption Test (Diagnostic Test).

a) Multicollinearity Test (VIF).

b) Heteroscedasticity Test.

c) Autocorrelation Test.

d) Residual Normality Test.

Then select the Panel Regression Model:

a) Chow Test → determines whether the appropriate model is Pooled Least Square (PLS) or Fixed Effect Model (FEM).

b) Hausman test → determines whether it is more appropriate to use the Fixed Effect Model (FEM) or Random Effect Model (REM).

c) Lagrange Multiplier Test (LM Test) → to test the choice between Random Effect Model (REM) and Pooled Least Square (PLS).

Next is to carry out a Hypothesis Test,

a) t-test → tests the influence of each independent variable on the dependent variable partially.

b) F test → tests the simultaneous influence of independent variables on the dependent variable.

c) Coefficient of Determination (R^2) → measures the extent of the contribution of the independent variable in explaining the dependent variable.

Data processing will use statistical software such as EViews which supports panel regression analysis.

RESULTS AND DISCUSSION

To move from individual narratives to sectoral understanding, descriptive statistics of the research variables are presented in Table 1. This provides crucial insights for interpreting subsequent econometric analysis, which reveals the fundamental characteristics and distribution patterns of the data (Winarsari & Zainuddin S, 2020; Kuntadi & Kristin, 2022).

Table 1

Variables	Means	Stdev	Min	Max
STABILITY	0.10	0.85	-0.22	4.02
ROE	0.05	0.13	-0.47	0.24
ROA	0.00	0.02	-0.07	0.02
CAR	0.21	0.07	0.12	0.43

NPF	0.02	0.02	0.00	0.08
GDP GROWTH	0.03	0.03	-0.05	0.08
INFLATION	0.02	0.01	-0.01	0.05
UNEMPLOYMENT	0.04	0.01	0.03	0.06

Source: Data processed by the author using EViews, 2025

The financial stability measures show a positive average, but the deviations from this average are very high. This indicates significant variation in the resilience of individual banks in the sample. The range, from an alarming -0.2250 (Bukopin Syariah, 2020) to a very strong 4.0283 (BSI, 2021), underscores that the ASEAN Islamic banking landscape is not monolithic; it comprises both highly vulnerable and highly resilient institutions, a finding consistent with the heterogeneous performance observed in a previous study by Salsabilla & Jaya (2024).

The capital adequacy ratio (CAR) is a prominent feature, with a healthy average of 21.23%, well above the regulatory minimum in Indonesia and Malaysia (typically 8-10%) as outlined by Ismaulina et al. (2020). This indicates a sector-wide conservative approach to capital management, likely influenced by regulatory pressures and risk-averse principles.

inherent in Sharia law. This substantial capital buffer, as theorized by Al-Manaseer (2024) and the World Bank (2020), can be said to provide a crucial cushion against pandemic shocks.

Profitability metrics indicate moderate overall performance, punctuated by periods of extreme stress. Average ROA of 0.45% and ROE of 5.81% reflect the moderate but stable profitability often associated with Islamic banking, which prioritizes sustainability over maximization (Miranti & Oktaviana, 2022). However, significantly negative minimum values for both ratios indicate that some institutions face significant profitability challenges, highlighting acute operational difficulties in certain market segments.

The asset quality indicator, NPF, averaged 2.79%, well below the general regulatory threshold of 5% (Fitri & Sriyana, 2023; Ikhsan, 2023). However, the maximum value of 8.83% indicates that at least one bank (Bukopin Syariah) experienced a severe decline in asset quality. This variation provides important insights into differences in risk management capabilities across institutions, broadening the understanding of the credit risk transmission mechanisms examined by Aledeimat & Bein (2025).

Macroeconomic variables complete the picture. The minimum negative value for GDP growth reflects the depth of the 2020 recession, while volatility in inflation reflects subsequent supply chain and demand-side shocks. Unemployment data adds a crucial socioeconomic layer, reminding us that banking stability is ultimately linked to the economic well-being of society.
These results make theoretical sense. They indicate that the factors that differentiate ASEAN Islamic banks in pursuing stability are largely influenced by the observed variables in the model

(such as CAR, NPF, ROA). This finding is in line with the notion that the sector, particularly among the large banks in the sample, operates under regulatory pressure and a relatively homogeneous market.

After confirming the model specifications, a core regression analysis was conducted using Combined OLS to examine the determinants of financial stability. The results, which directly address the research questions, are presented in the following table:

Table 2. OLS Regression Results

Variables	Coefficient	Error	Stat (t)	Possible.
C	0.45	0.28	1.61	0.11
ROE	0.38	0.71	0.54	0.59
ROA	5.89	3.50	1.68	0.09
CAR	0.50	0.96	0.52	0.60
NPF	-2.45	3.01	-0.81	0.41
GDP GROWTH	0.89	1.89	0.47	0.63
INFLATION	-3.12	2.73	-1.14	0.25
COVID	0.06	0.14	0.46	0.64
UNEMPLOYMENT	-10.4	4.12	-2.53	0.01

Source: Data processed by the author using EViews, 2025

R-squared	0.18
Adjusted R-squared	0.08
F statistic	1.82
Prob (F-statistic)	0.09

The results for the internal financial performance variables show the expected relationship with a surprising level of significance. Return on Assets (ROA) emerged as the only financial metric statistically significant at the 10% level, with a strong positive coefficient (5.892). This finding is profound. It indicates that a 1 percentage point increase in ROA is associated with a 5.892-point increase in the stability measure. This underscores that fundamental operational efficiency, the ability to generate profits from assets, is a critical pillar of resilience. This finding provides strong empirical validation for the profitability-stability relationship theorized by Pranoto & Arifin (2025), which suggests that profitable banks are better equipped to absorb shocks and maintain trust.

In contrast, Return on Equity (ROE) and Capital Adequacy Ratio (CAR) show positive but statistically insignificant coefficients. The insignificance of ROE suggests that, from a stability perspective, how efficiently a bank utilizes its equity (which can be inflated by leverage) is less important than how efficiently it utilizes its total assets (ROA). This aligns with the precautionary principle regarding leverage emphasized in Islamic finance principles (Jitmaneeroj & Ogwang, 2023). The insignificance of CAR, while seemingly counterintuitive, can be

interpreted within the context of the sample. Most banks maintain CAR levels well above the established minimum threshold, as shown in the descriptive statistics. This may indicate a "threshold effect," whereby after a certain point, additional capital does not contribute significantly to further stability, a nuance highlighted by Al-Manaseer (2024).

Non-Performing Loans (NPF) has a negative coefficient (-2.457), confirming the theoretical expectation that asset quality deterioration undermines stability. However, the lack of statistical significance (p-value 0.418) indicates that in this specific sample and time period, the effect is not uniform across all banks. This could be due to effective provisioning or recovery management by some institutions, which mitigates the destabilizing impact of NPF, as observed by Kusnaedy et al. (2025).

The COVID-19 dummy variable is positive but insignificant, a result that may seem paradoxical. However, this likely reflects the net impact of the pandemic: the initial negative shock was likely offset by substantial fiscal and monetary support, regulatory easing, and the subsequent sharp recovery, resulting in no statistically significant net negative impact on stability over the entire period.

The model's R-squared value of 0.18 indicates that the included variables explain approximately 18.7% of the variation in financial stability. While this may seem modest, it is common in cross-sectional and panel studies of firm performance, where unobserved firm-specific strategies and random shocks play a significant role.

CONCLUSION

A comprehensive investigation into the stability of ASEAN Islamic banking during the pandemic era has revealed a complex picture that challenges simplistic narratives and leads to a more nuanced understanding of what drives financial resilience in Islamic banking systems.

The main finding of this study, namely that unemployment dominates traditional financial metrics as a determinant of stability, suggests the need for us to rethink conventional financial stability models when applied to Islamic banking.

Based on the problem formulation, hypothesis testing and discussion presented in the previous chapters, it can be concluded that:

a) ROA has been shown to have a positive and significant effect on financial stability. ROA emerged as the most significant internal determinant of financial stability. The strong positive relationship ($\beta = 5.89$, $p < 0.1$) underscores that operational efficiency and fundamental profitability are important pillars of banking resilience.

b) ROE is shown to have a positive but insignificant effect on financial stability. The regression reveals a nuanced reality where capital buffers beyond regulatory requirements and shareholder returns may offer diminishing marginal stability benefits compared to fundamental earnings capacity.

c) CAR is proven to have a positive but insignificant effect on financial stability. Although it shows a positive relationship, its statistical insignificance indicates a threshold effect where additional capital provides diminishing stability benefits.

d) NPF is shown to have a negative but insignificant effect on financial stability. shows the expected negative relationship but is not statistically significant in the overall model, which indicates the diversity of risk management capabilities across institutions.

e) Unemployment has been shown to have a positive but insignificant effect on financial stability. Regarding the impact on economic performance, this study reveals the surprising dominance of socio-economic factors, particularly unemployment, which emerged as the single most powerful determinant of financial stability.

f) GDP and inflation are proven to be positive and significant towards financial stability. Unemployment which emerges as the single strongest determinant towards financial stability qualifies

Based on the research findings, several recommendations are proposed for consideration by both Islamic banking practitioners and regulators, as well as for future research development. The following practical suggestions are directed to Islamic commercial bank management and regulators as strategic recommendations based directly on empirical findings.

a) Strategic Focus on Sustainable Profitability: The dominance of ROA as a key determinant of financial stability suggests that management should prioritize fundamental business model efficiency over short-term financial engineering or excessive leverage.

b) Enhanced Stress Testing Banks should develop more sophisticated stress testing models that incorporate labor market variables and scenario analysis based on unemployment shocks.

c)Differentiated Crisis Preparedness Smaller institutions should maintain more conservative capital and liquidity buffers given their proven vulnerability to economic shocks.

d) Enhancement of Macroprudential Policy. The regulatory framework should include unemployment indicators as an early warning signal of financial stability risks.

e) Differentiated Supervision. The heterogeneous impact of the crisis demonstrates the need for tiered regulatory requirements based on bank size and business model resilience.

f) Crisis Response Design. Emergency facilities and support programs should be designed taking into account the varying needs of different bank categories.

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