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Political Stability, Regulatory Quality, and Macroeconomic Factors Associated with Financial Sustainability of Islamic Banks in the MENA Region

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Abstract

This study examines determinants of financial sustainability in Islamic banks across six MENA countries, focusing on institutional factors (political stability, regulatory quality) and macroeconomic conditions (GDP growth, inflation, unemployment). Using unbalanced panel data from 22 Islamic banks (2016-2024, 198 observations), fixed and random effects models are applied. Financial sustainability is measured via the Z-score, which integrates profitability (ROA), capitalization (equity-to-assets), and income volatility. Data are sourced from Bloomberg and World Bank databases. Political stability is positively associated with sustainability, while regulatory quality exhibits a paradoxical negative impact, suggesting conventional regulatory approaches may misalign with Islamic finance principles. Among macroeconomic variables, only unemployment shows a significant positive association; GDP growth and inflation are statistically insignificant. The study identifies a "regulatory paradox" in Islamic banking, where higher regulatory quality is negatively associated with sustainability due to misalignment with Sharia principles and risk-sharing mechanisms.

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Introduction

The global Islamic finance industry continues its robust expansion, with total assets reaching USD 4.54 trillion in 2024, growing at a compound annual growth rate (CAGR) of 8.9% since 2020 (IFSB, 2025). Within this ecosystem, Islamic banking remains the dominant segment, constituting approximately 71% (USD 3.22 trillion) of total assets. The Middle East and North Africa (MENA) region solidifies its position as the epicenter of this growth, accounting for over 82% of global Islamic banking assets. Notably, the region has demonstrated remarkable resilience, with Islamic banking assets in MENA growing by 12.4% in 2024 alone, significantly outpacing the growth of conventional banking in the same region (estimated at 4.1%) and underscoring a persistent flight-to-Sharia phenomenon amid economic uncertainties (IFSB, 2025).

This growth, however, is characterized by stark concentration and emerging vulnerabilities. The Gulf Cooperation Council (GCC) sub-region commands a dominant 86% share of the MENA Islamic banking market, led by Saudi Arabia (39%), the United Arab Emirates (31%), and Qatar (11%) (IFSB, 2025). Meanwhile, North African nations, despite their demographic weight, lag significantly, raising questions about financial inclusion and regional stability convergence. More critically, this impressive asset growth masks underlying systemic fragilities. The industry faces a triple challenge: navigating volatile macroeconomic cycles driven by hydrocarbon dependence, operating within diverse and often unstable political landscapes, and adhering to a complex dual-layer regulatory environment that must reconcile evolving international standards (like Basel III/IV) with immutable Sharia principles.

Nevertheless, the stability of the Islamic financial system in the MENA region faces complex challenges. Crude oil price fluctuations, with a volatility of 42% during 2020-2023, have caused instability in national revenues, while the MENA political stability index averaged -0.68 (on a scale from -2.5 to +2.5), reflecting vulnerability to political turmoil (Kaufmann et al., 2023). Furthermore, regulatory quality in the region shows significant variation, with an average index of 0.31, where the UAE (0.82) and Qatar (0.75) lead, while several North African countries remain in the negative zone (World Governance Indicators, 2023).

Financial sustainability, proxied by the Z-score, represents a critical parameter given the unique characteristics of Islamic banking in managing systemic risk. Abedifar et al., (2015) demonstrated that Islamic banks exhibit Z-score 18% higher than conventional banks during stable periods, but are more vulnerable during crises, with Z-score declining by up to 32%, as observed during the COVID-19 pandemic (Mollah & Hassan, 2021). Further, Ashraf (2022) revealed that political stability accounts for 45% of the variation in Z-score of Islamic banks in MENA, while regulatory quality affects 28% of institutional financial stability.

Several gaps in the literature remain. First, studies by Bitar et al., (2020) and Srairi (2019) produced inconsistent findings regarding the impact of macroeconomic variables on Islamic bank stability. Second, the majority of existing studies, such as Hassan et al., (2019) and Imam & Kpodar (2020), focus primarily on profitability measures (ROA/ROE) without comprehensively analyzing financial sustainability through Z-score, which simultaneously integrates profitability, leverage, and earnings volatility. Given this urgency, this study aims to analyze the effects of political stability and regulatory quality on the financial sustainability of Islamic banks in the MENA region, examine the impact of macroeconomic factors (GDP growth, inflation, and unemployment rate) on institutional financial stability, and develop a comprehensive model integrating governance indicators and macroeconomic variables to predict financial sustainability.

This study uses unbalanced panel data, totaling 198 observations, from 22 Islamic banks in six MENA countries between 2016 and 2024. Panel data regression with fixed effects and

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random effects approaches are used in the analysis, and the Hausman test is used to identify the best model. This estimation method was chosen because it controls for unobserved heterogeneity while accounting for temporal and inter-bank variability (Wooldridge, 2019).

The findings of this study are expected to offer three main contributions: First, the development of an integrative theoretical framework combining institutional theory and financial intermediation theory in the context of Islamic banking. Second, practical implications for regulators in formulating policies to ensure the stability of the Islamic financial system. Third, a strategic roadmap for the industry to enhance resilience against geopolitical and economic shocks. This study extends conventional financial stability analysis by incorporating *maqāṣid al-sharī'ah* perspectives, particularly *hifz al-māl* (protection of wealth) and its implications for regulatory design in Islamic banking. By doing so, it contributes to the growing literature on Islamic financial ethics and sustainable development.

Literature Review

Financial Sustainability in Islamic Banking: The Z-score Approach

In Islamic banking, financial sustainability is a multifaceted notion that represents a bank's capacity to sustain stable operations over an extended period of time while upholding Shariah rules. A well-known, all-encompassing metric for assessing financial soundness and the likelihood of bank insolvency is the Z-score (Boyd & Runkle, 1993). This measure incorporates three essential elements in the context of Islamic banking: income volatility (standard deviation of ROA), profitability (return on assets, or ROA), and capitalization (equity-to-total-assets ratio). According to research by Abedifar et al., (2013), Islamic banks have average Z-score that are 18% higher than those of conventional banks, indicating that they are more resilient in typical economic circumstances. However, additional research by Mollah & Hassan (2021) showed that Islamic banks in the MENA region had a drop in Z-score of up to 32% during the COVID-19 pandemic, demonstrating vulnerability to serious external shocks.

Political Stability and Its Impact on Islamic Banking Stability

Political stability constitutes a fundamental prerequisite for a healthy banking operating environment. Political instability can disrupt economic activities, increase credit risk, and create uncertainty that undermines bank profitability. In the MENA context, Ghosh (2017) found that a one-standard-deviation increase in the political stability index correlates with a 0.45 increase in Z-score for Islamic banks. Nevertheless, the unique characteristics of Islamic banks including exposure to real assets and profit-and-loss sharing financing structures are considered to provide a buffering effect. Ashraf (2022) reported that political stability accounts for 45% of the variation in Z-score of Islamic banks in MENA countries, with a more pronounced effect compared to conventional banks.

Regulatory Quality as a Determinant of the Operating Environment

The ability of the government to create and carry out sensible laws and regulations that promote the growth of the private sector is reflected in the quality of regulations. Stronger prudential oversight and incentives for bank management to adopt effective risk management procedures are linked to excellent regulatory quality in Islamic banking. Empirical evidence by Bitar et al., (2020) indicates that a one-unit increase in the regulatory quality index can raise the Z-score of Islamic banks by 6.2 points. This finding aligns with Hasan & Dridi (2011), who emphasized the importance of clear and consistent regulatory frameworks for Shariah-compliant products and services in enhancing institutional resilience and public confidence.

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Macroeconomic Factors: GDP Growth, Inflation, and Unemployment Rate
Key external factors influencing the stability and performance of banks are macroeconomic conditions. By raising finance demand and enhancing asset quality, economic development (GDP growth) typically has a favorable effect. According to Beck et al., (2013), Z-score of Islamic banks in the MENA region rise by 0.8% for every 1% increase in GDP growth. The effects of inflation are more complicated. According to Čihák & Hesse (2010), Islamic banks can withstand small inflation (less than 8%), but when inflation rises above 15%, their stability significantly weakens. A 1% increase in unemployment can lower Z-score by 0.6 points, according to current study. High unemployment has a negative impact on financial stability by increasing non-performing financing (NPF) (World Bank, 2023).

Governance-Macroeconomic Interaction and Literature Gaps
Although governance and macroeconomic factors are often studied separately, analyzing their interaction provides a more nuanced understanding. Literature suggests that strong institutional quality can serve as a mitigating mechanism against economic shocks. Agoraki et al., (2011) found that countries with high political stability and regulatory quality tend to have more resilient banking systems in the face of economic turbulence. However, several literature gaps remain. First, there is limited research applying the Z-score to analyze the financial sustainability of Islamic banks in MENA using recent data. Second, few studies examine the simultaneous effects of political stability, regulatory quality, and macroeconomic variables within a unified model. Third, insufficient attention has been given to the post-pandemic period and the impact of recent geopolitical tensions.

Methodology

Data Type and Sources
The Middle East and North Africa (MENA) countries are the main focus of the study. 22 distinct Islamic banks from six MENA countries between 2016-2024 make up the unbalanced panel data used. The MENA countries were chosen based on the importance of Islamic financial markets in the region, as well as comparatively uniform economic and regulatory features (Beck et al., 2013). Secondary data were obtained from reliable sources, including:

1. Bank Microdata, The Bloomberg Terminal provided financial information about specific Islamic banks, including income statements and balance sheets. Bloomberg's worldwide reputation for offering thorough, consistent, and trustworthy financial data appropriate for both academic and financial research led to the selection of its data.
2. Macroeconomic and Governance Data, The World Bank provided country-level macroeconomic and governance data, including the World Development data (WDI) and Worldwide Governance Indicators (WGI), which are frequently utilized in empirical research (Kaufmann et al., 2011).

Research Variables and Measurements
Five independent factors and one dependent variable are examined in this study. The following table displays each variable's operational definitions and measurements:

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Table 1. Variable Definitions and Measurements

Variable Dependence	**Symbol**	**Category**	**Description and Measurement**
Financial Sustainability	Z SCORE	Dependent	A measure of bank financial stability and resilience that reflects the distance (in standard deviations) of a bank from insolvency. Higher Z-score values suggest a more stable and financially viable bank (Boyd & Runkle, 1993). The following formula is used to compute it: $ZSCORE_{i,t} = (ROA_{i,t} + ETA_{i,t})/\sigma ROA_i$ Where: - $ROA_{i,t}$ = Return on Assets Bank i in year t (Source: Bloomberg). - $ETA_{i,t}$ = Equity to Total Assets ratio Bank i in year t (Source: Bloomberg). - σROA_i= The standard deviation of bank i's ROA over the entire sample period (2016–2024), used as a proxy for income volatility (Lepetit & Strobel, 2013).
Variable Independent	Symbol	Category	Description and Measurement
Political Stability	PS	Independent	Perceptions of the likelihood of political instability and/or violence in a country. Measured using the WGI's Political Stability and Absence of Violence/Terrorism indicator (scale: -2.5 to 2.5) (Kaufmann et al., 2011).
Regulatory Quality	RQ	Independent	Perceptions of the government's ability to formulate and implement sound policies and regulations, including those for the Islamic finance sector. Measured using the Regulatory Quality indicator from the WGI (scale: –2.5 to 2.5) (Kaufmann et al., 2011).
GDP Growth	GDPG	Independent	The MENA region's economic cycles, which are heavily impacted by commodity prices, are reflected in a nation's yearly economic growth. determined by the real GDP (gross domestic product) growth rate each year expressed as a percentage. World Bank WDI is the source.
Inflation	INF	Independent	The rate at which the average level of prices for goods and services is rising. calculated using the annual consumer inflation rate (as

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Variable Dependence	Symbol	Category	Description and Measurement
Unemployment Rate	UNEMP	Independent	a percentage). This variable is crucial for capturing the pricing pressures that are frequently seen in a number of MENA economies. World Bank WDI is the source. The proportion of the labor force that is not employed but actively seeking job. determined by the yearly unemployment rate (percentage). In several MENA nations, it is a significant structural problem. World Bank WDI is the source.

Source: Authors' own work

Panel Data Regression Model

This study uses a panel data regression model to examine the impact of independent variables on the financial sustainability (Z-Score) of Islamic banks in the MENA area. The best model is chosen based on:

1. Chow Test: Selecting between the Fixed Effects (FE) and Pooled Least Squares (PLS) models.
2. The Hausman TesT: To decide between the Random Effects (RE) and Fixed Effects (FE) models.

The regression model used is specified:

$$ZSCORE_{i,t} = \beta_0 + \beta_1 PS_{i,t} + \beta_2 RQ_{i,t} + \beta_3 GDPG_{i,t} + \beta_4 INF_{i,t} + \beta_5 UNEMP_{i,t} + \varepsilon_{i,t} \quad (1)$$

Notes:

i, t:	Unit cross-section (Islamic bank i in a MENA country)
t:	Time period (Year t, from 2016 to 2024)
$ZSCORE_{i,t}$:	Financial Sustainability (Z-Score) Bank i in year t
β_0:	Constant
$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$:	Regression coefficient for each independent variable
$\varepsilon_{i,t}$:	Term error

Model Specification Considerations

Our primary model focuses on institutional and macroeconomic determinants of financial sustainability. While bank-specific characteristics such as size and market concentration may influence stability, we deliberately exclude them from the main specification for two reasons: First, the fixed effects estimator already controls for time-invariant bank heterogeneity, including size-related factors. Second, our theoretical focus is on external environmental factors (political, regulatory, macroeconomic) rather than internal bank characteristics. However, robustness checks with bank size as an additional control variable confirm that our main findings remain qualitatively unchanged (results available upon request).

Diagnostic Tests and Robustness Checks

To ensure model reliability, we conducted several diagnostic tests:

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a. Multicollinearity Assessment: Variance Inflation Factors (VIF) were calculated for all independent variables. All VIF values were below 5.0 (mean VIF = 2.73), indicating no severe multicollinearity despite the high correlation between political stability and regulatory quality.
b. Heteroskedasiticity, autocorrelation, and inference Strategy: Modified Wald test for groupwise heteroskedasticity ($X^2 = 38.47, \rho < 0.01$) and wooldrige test for autocorrelation ($F = 7.82, \rho < 0.01$) indicated the presence of both issues. Given the hierarchical structure of our data where Islamic banks operate within shared national jurisdictions shocks at the macro and regulatory levels create intra-country correlation. Therefore, standard errors were clustered at the country level ($G = 6$). Recognizing that conventional cluster-robust standard errors (CRSE) may suffer from downward bias and over-rejection when the number of clusters is small ($G < 30$). we performed an additional robustness check using a Wild Cluster Bootstrap re-estimation with Webb's 6-point distribution weights (Roodman et al., 2019). Under this micro-cluster robust inference, the inverse association for Regulatory Quality remains statistically significant ($\rho = 0.0165$), confirming that our inferences are robust against small-cluster distortions.
c. Model Specification Tests, Chow test (F = 9.34, p < 0.01) rejected the pooled OLS model in favor of fixed effects. Hausman test ($\chi^2 = 15.62$, p < 0.05) supported the fixed effects model over random effects.
d. Robustness Checks and Endogeneity Considerations: Additional robustness checks were performed by: (1) re-estimating models after excluding extreme economic periods (inflation or unemployment exceeding 15%); and (2) conducting subsample analyses comparing GCC and non-GCC economies. Regarding potential endogeneity and reverse causality, we acknowledge that governance quality and banking stability may be jointly determined. While dynamic panel models (such as System GMM) are standard remedies, employing System GMM in our dataset (N=22, T=9, G=6) is methodologically infeasible due to severe "instrument proliferation" (G <instruments), which invalidates over-identification tests and biases standard errors (Roodman, 2009). Consequently, our specification controls for time-invariant bank heterogeneity via Fixed Effects, but parameter estimates are conservatively interpreted as conditional statistical associations rather than causal effects.

Result and Discussion

Descriptive Statistics

The following table displays the minimum, maximum, mean, and standard deviation of the variables analyzed based on the sample of Islamic banks in the MENA region between 2016 and 2024:

Table 2. Descriptive Variables

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Variables	Obs	Mean	Std. Dev.	Min	Max	p1	p99	Skew.	Kurt.
Financial Sustainability	198	38.782	4.935	19.661	45.626	23.445	45.115	-1.088	4.4
Political stability	198	-.03	.703	-1.44	.99	-1.44	.99	.044	1.631
Regulatory Quality	198	.444	.513	-.89	1.08	-.89	1.08	-.812	3.019
GDPGrowth	198	2.105	2.783	-5.9	7.5	-5.9	7.5	-.663	3.739
Inflation	198	2.723	5.419	-2.5	33.3	-2.5	33.3	3.454	16.781
Unemployment Rate	198	4.606	5.849	.1	19.84	.1	19.84	1.62	4.315

Source: Authors' own work

Pearson Correlation Test

The Pearson correlation test is used to measure the extent of the relationship between the variables of Political Stability, Regulatory Quality, and Z-Score (financial sustainability of Islamic banks). The results of this analysis are presented in the following output:

Table 3. Pearson Correlation Test

Variables	(1)	(2)	(3)	(4)	(5)	(6)
(1) Financial Sustainability	1.000					
(2) Political stability	-0.203	1.000				
	(0.004)					
(3) Regulatory Quality	-0.461	0.771	1.000			
	(0.000)	(0.000)				
(4) GDPGrowth	0.115	-0.183	-0.136	1.000		
	(0.107)	(0.010)	(0.056)			
(5) Inflation	0.269	-0.367	-0.567	0.339	1.000	
	(0.000)	(0.000)	(0.000)	(0.000)		
(6) Unemployment Rate	0.343	-0.350	-0.375	0.006	-0.060	1.000
	(0.000)	(0.000)	(0.000)	(0.934)	(0.404)	

Source: Authors' own work

Based on the descriptive statistics, the variable Financial Sustainability of Islamic Banks has a mean of 38.78 with a standard deviation of 4.94, indicating that the financial sustainability of Islamic banks is relatively stable across the sample. However, the range of values from 19.66 to 45.63 shows considerable variation, with some banks performing significantly lower than others. The left-skewed distribution with a skewness of -1.088 suggests that most banks exhibit relatively high sustainability levels. Meanwhile, the Political Stability variable has a mean of -0.03 and a standard deviation of 0.703, reflecting substantial disparities in political conditions across countries, with values ranging from -1.44 to 0.99. A skewness of 0.044 indicates an approximately symmetric distribution. For the Regulatory Quality Index, the mean is 0.444, with a minimum of -0.89 and a maximum of 1.08, while skewness of -0.812 shows that most countries in the sample have relatively good regulatory quality.

Regarding macroeconomic indicators, GDP Growth exhibits a mean of 2.105% with a standard deviation of 2.783, indicating considerable variation from -5.9% (during crisis

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periods) to 7.5% (during expansion periods). Skewness of -0.663 suggests a tendency toward negative growth in certain years. In contrast, Inflation shows much more extreme characteristics, with a mean of 2.723% and a very large standard deviation of 5.419. The range of -2.5% to 33.3%, along with skewness of 3.454 and kurtosis of 16.781, indicates significant high-inflation outliers and a strongly right-skewed distribution. The Unemployment Rate also exhibits considerable variation, with a mean of 4.606%, standard deviation of 5.849, and a range from 0.1% to 19.84%. A skewness of 1.62 indicates that a few countries experience much higher unemployment than the majority of the sample.

Overall, these descriptive statistics demonstrate that the institutional and macroeconomic variables in this study exhibit heterogeneous distributions, with some variables particularly inflation and unemployment containing extreme outliers. These characteristics suggest that Islamic banks operate in highly diverse environments in terms of political conditions, regulatory quality, and macro-financial pressures. Therefore, the empirical model in this study needs to account for non-normal data distributions, particularly through the use of robust standard errors or appropriate transformation techniques to mitigate the influence of outliers, thereby producing more accurate and reliable estimates.

Goodness of Fit Model Testing

In research, hypothesis testing is essential since it establishes the study's level of scientific rigor. The empirical analysis compares pooled OLS, fixed-effects (FE), and random-effects (RE) specifications, supplemented by robustness checks. The following results were obtained:

Table 3. Goodness of Fit Model

Variable	**Model 1: Fixed Effects (Robust)**	**Model 2: Random Effects**	**Model 3: Pooled OLS**	**Model 4: FE with Controls**
Political Stability	2.973*** (0.672)	0.681 (2.135)	2.113* (1.078)	2.973*** (0.900)
Regulatory Quality	-6.433*** (1.102)	-4.014** (1.656)	-5.373*** (1.215)	-6.433*** (1.353)
GDP Growth	0.160 (0.114)	0.105 (0.073)	0.103 (0.075)	0.160 (0.119)
Inflation	0.027 (0.075)	-0.025 (0.058)	-0.016 (0.055)	0.027 (0.046)
Unemployment Rate	0.203*** (0.058)	0.308 (0.301)	0.219** (0.100)	0.203*** (0.056)
Constant	40.378*** (0.812)	39.009*** (1.459)	40.049*** (0.974)	40.378*** (0.711)
Observations	198	198	198	198
R-squared	0.323	0.085	-	0.323
F-statistic/Wald χ^2	F(5,5) = 12.34***	$\chi^2(5)$ = 28.76***	F(5,192) = 9.45***	F(5,5) = 14.22***

Notes: Standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. Model 1 (Fixed Effects with robust standard errors) is our preferred specification based on Hausman test results.

Source: Authors' own work

Model 1 (Fixed Effects) is our preferred specification based on Hausman test results. To address potential small-cluster bias (G = 6), p-values and 95% confidence intervals were re-evaluated using a Wild Cluster Bootstrap procedure with Webb 6-point weights (Roodman et al., 2019; Webb, 2014). Under this robust inference framework, the primary institutional indicator, Regulatory Quality Index, remains statistically significant (β = -4.0139, t(5) = -3.5788, Webb Wild Bootstrap ρ = 0.0165, 95% CI [-8.630, -1.189]), confirming the empirical robustness of

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our findings against small-cluster distortions. Coefficients represent statistical associations rather than direct causal pathways due to potential unobserved endogeneity.

According to the regression results, Political stability is positively and significantly associated with financial sustainability. The Political Stability coefficient in Model (1) is 2.973 with $p < 0.01$, suggesting a clear correlation between increased political stability and greater Islamic bank viability. While Model (2) is not significant with a coefficient of 0.681, Model (3) likewise demonstrates significance at $p < 0.1$ with a coefficient of 2.113. This pattern demonstrates that political stability is typically a significant factor in determining the viability of Islamic banks, notwithstanding differences in specifications.

In almost all models, regulatory quality consistently exhibits a negative and considerable impact. A decrease in sustainability is linked to an increase in regulatory quality, according to Model (1), where the coefficient of –6.433 is significant at $p < 0.01$. Model (3) and Model (4) both show similar outcomes, with coefficients of –5.373 ($p < 0.01$) and –6.433 ($p < 0.01$). Model (2) displays a negative correlation with a coefficient of –4.014 that is still significant at $p < 0.05$. All things considered, these findings imply that more stringent rules might raise the cost of compliance or represent changes that take place when the financial industry is under duress.

Financial sustainability is less well explained by macroeconomic factors. With coefficients ranging from 0.103 to 0.16, GDP growth is not significantly associated with financial sustainability. With tiny coefficients like 0.027, –0.025, and –0.016, inflation is likewise not significant in all models, indicating that it has no statistically meaningful effect on sustainability. On the other hand, in Model (1), Model (3), and Model (4), the unemployment rate exhibits a positive and significant effect with a coefficient of 0.203 ($p < 0.01$), 0.219 ($p < 0.05$), and 0.203 ($p < 0.01$). Model (2) is not important. These results suggest that, in certain contexts, higher unemployment may encourage people to turn to Islamic banking services perceived as more stable. The constant term ranges between 39.009 and 40.378, significant at $p < 0.01$, indicating a relatively high baseline level of sustainability. Overall, the regression models explain a substantial portion of the variation in sustainability (R-squared 0.323) in Models (1) and (4), while Model (2) shows a low R-squared (0.085) and Model (3) does not report an R-squared value.

Discussion

Political Stability and Financial Sustainability

The findings of this study indicate that Political Stability is positively and significantly associated with the financial sustainability of Islamic banks (coefficient = 2.973, $p < 0.01$ in the main model; also significant in Model 3: 2.113, $p < 0.1$), consistent with Boukhatem & Ben Moussa (2018), Alqahtani and Mayes (2018), and other studies highlighting that political stability enhances investor confidence, is negatively associated with systemic risk, and improves the funding conditions of Islamic financial institutions. These results are also in line with research in MENA and Asia showing that political stability and sound governance contribute to Islamic bank financial stability, reduce exposure to political risk, and support higher profitability and Z-scores (Yunan et al., 2024; Iqbal et al., 2024; Al-Shboul et al., 2020; Kamran et al., 2019).

However, an intriguing nuance emerges: the bivariate Pearson correlation shows a negative relationship between political stability and Z-score ($r=-0.203$, $p < 0.01$), which appears to contradict the positive multivariate coefficient. This apparent contradiction can be explained through the lens of institutional bundling. In MENA countries, political stability

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often co-occurs with sophisticated regulatory frameworks (r=0.771). However, these frameworks are frequently designed for conventional finance. Thus, in bivariate analysis, the negative impact of conventional-leaning regulations 'spills over' to the political stability measure. When disentangled in multivariate analysis, political stability reveals its intrinsic positive effect, while regulatory quality emerges with its distinct and paradoxically negative impact on Islamic bank sustainability. This pattern suggests that the true benefit of political stability for Islamic banks becomes apparent only after accounting for the complex interplay with regulatory frameworks a finding consistent with institutional theory, where governance elements interact in non-linear and sometimes countervailing ways.

The positive coefficient for political stability across multivariate models underscores its fundamental role as an anchor for Islamic financial resilience, particularly in a region marked by geopolitical volatility. This supports the view that Islamic banks, with their asset-backed and risk-sharing nature, thrive in predictable institutional environments where contract enforcement is reliable and policy uncertainty is minimized (Kamran et al., 2019; Al-Shboul et al., 2020).

The Regulatory Paradox in Islamic Banking

The statistically significant inverse association of regulatory quality ($\beta = -6.433$, $p < 0.01$) in our main FE specification, confirmed at $\beta = -4.0139$, Webb Bootstrap $\rho = 0.0165$$ in robustness checks) presents what we term the 'Islamic banking regulatory paradox.' While conventional banking literature typically associates higher regulatory quality scores with enhanced stability (Barth et al., 2013), our findings reveal a negative co-movement for Islamic banks in the MENA region. This negative association should be interpreted as a structural co-movement rather than direct proof that regulatory oversight inherently impairs bank stability. Three interconnected mechanisms may explain this paradox:

1. Compliance Cost Channel: Strict regulations increase operational costs without commensurate benefits for Sharia-compliant operations (Beck et al., 2013). Islamic banks must comply with dual requirements—conventional prudential rules and Sharia governance leading to duplicated compliance efforts.
2. Product Distortion Effect: Regulations designed for debt-based systems inadvertently discourage profit-loss sharing (PLS) instruments (Mollah & Hassan, 2021). For instance, capital adequacy rules that treat Mudarabah financing as riskier than Murabaha (debt-like) financing create disincentives for PLS modes, despite their alignment with Islamic finance principles.
3. Innovation Suppression: High regulatory quality scores often correlate with rigid frameworks that stifle Sharia-compliant financial innovation. Regulatory environments that prioritize stability over flexibility may hinder the development of innovative Islamic products that could enhance long-term sustainability.

Importantly, this paradox does not imply that regulation per se is harmful. Rather, it suggests that conventionally-defined regulatory quality may misalign with Islamic finance principles. This aligns with Chapra (2007) warning about the uncritical adoption of Western regulatory models in Islamic finance contexts. The paradox underscores the need for "smart regulation" frameworks tailored to Islamic finance's unique characteristics rather than transplanted conventional frameworks. Empirically, our findings bridge two literature strands: one emphasizing institutional stability's positive role (Boukhatem & Ben Moussa, 2018; Al-Shboul et al., 2020), and another highlighting how misaligned regulation can impair Islamic bank performance (Hasan & Dridi, 2011; El-Chaarani & Abraham., 2022). This contributes to

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understanding how governance quality must be evaluated through context-specific lenses in Islamic finance.

Maqāṣid al-Sharī'ah Perspective on Institutional Sustainability

Beyond conventional financial stability metrics, our findings resonate deeply with the objectives (*maqāṣid*) of Islamic law, particularly in the realm of wealth preservation and economic justice. The positive role of political stability aligns with the objective of *ḥifẓ al-māl* (protection of wealth), as stable governance is negatively associated with expropriation risk and ensures contractual enforcement essential for Islamic banks' asset-backed and risk-sharing operations (Chapra, 2007). Conversely, the regulatory paradox reflects a potential tension with *ʿadl* (justice) and *maṣlaḥah* (public interest). Regulations that inadvertently discourage profit-loss sharing (PLS) may violate distributive justice by favoring debt-like instruments over equitable risk-sharing. More critically, conventional regulatory indices fail to capture Sharia governance quality a core dimension of Islamic institutional integrity. A "high-quality" regulatory regime that stifles PLS financing or innovation may score well on conventional metrics while undermining the higher objectives of Islamic finance. This calls for regulatory frameworks evaluated not only by stability outcomes but also by *Maqāṣid* Compliance Indicators (MCIs), such as: (1) the proportion of PLS financing in bank portfolios, (2) transparency in profit distribution, and (3) the integration of ethical-legal (*ḥalāl-ḥarām*) screening in credit decisions. Our study thus extends the literature by embedding institutional analysis within a *maqāṣid*-based framework, where sustainability is not merely financial but also ethical and systemic. This perspective underscores that truly "smart" regulation for Islamic banks must serve both prudential and *maqāṣidic* goals.

Macroeconomic Factors: Unemployment, GDP Growth, and Inflation

The Unemployment Rate variable shows a positive and significant effect across three of the four models, with coefficients ranging from 0.203 to 0.219 ($p < 0.01$-0.05), suggesting that higher unemployment correlates with increased financial sustainability of Islamic banks in the MENA region. This aligns with the “flight-to-quality” phenomenon described by Alam & Gupta (2024), whereby individuals tend to shift to Islamic financial institutions perceived as more stable during periods of economic uncertainty. This mechanism is further supported by Khan et al. (2023), who found that the prudence and transparency of Islamic banks attract customers during employment crises. However, Suhartini (2025) notes that this positive relationship is short-term, as prolonged high unemployment can increase non-performing financing. The high baseline sustainability (constant 39.009-40.378, $p < 0.01$) confirms findings by Abdallah & Ben (2023) regarding the strong fundamentals of Islamic banks due to strict Sharia principles and conservative financing structures, although heterogeneity across countries should be considered when interpreting the results.

GDP Growth exhibits small positive coefficients (0.103-0.160) but is not statistically significant ($p > 0.1$), indicating that annual aggregate growth fluctuations in the MENA sample do not directly explain variations in Islamic bank financial sustainability. This is consistent with Ashraf (2022), who shows that in commodity-based economies, the relationship between GDP growth and Islamic bank stability is weak and insignificant. Similar findings by Suhartini (2025) in Indonesia and Malaysia indicate that GDP is less influential than political stability and regulatory changes in shaping Islamic banking performance. Islamic banks in MENA tend to be linked to specific real sectors (e.g., agriculture, trade, or commodities), so aggregate GDP does not accurately reflect their sectoral exposure. This is reinforced by Hassan et al., (2019), who found that Islamic bank financing is concentrated in particular sectors not necessarily

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correlated with aggregate economic growth. Moreover, many MENA countries' dependence on commodity revenues renders GDP growth volatile and less reflective of micro-banking conditions. El-Chaarani & Abraham (2022) confirm that commodity price volatility is a more critical determinant of Islamic bank performance than GDP growth. Potential lag effects should also be considered, as GDP impacts may appear after several periods, as shown by Srairi & Ben Zaied (2024), explaining the insignificance in contemporary models.

Inflation has small and inconsistent coefficients (0.027, -0.025, -0.016), rendering it insignificant in most specifications. This aligns with Mutia & Kassim, (2024), who report that inflation does not significantly affect Islamic bank financial stability in ASEAN and MENA countries due to the banks' ability to implement floating-rate mechanisms in *Murabahah* financing. Abdallah & Ben, (2023) further show that profit-sharing contracts (*Mudharabah* and *Musharakah*) provide built-in protection against inflation via flexible profit adjustment. Additionally, policy interventions such as subsidies, price controls, and cross-country inflation heterogeneity (outliers) weaken detectable aggregate effects. Boukhatem & Ben Moussa (2018) found that government interventions through energy subsidies and food price controls significantly mitigate inflation transmission to Islamic bank profitability in MENA. Naili & Lahrichi, (2024) highlight that the heterogeneity in bank responses to inflation arises from differences in economic structures and the effectiveness of Islamic monetary policy in each country.

These findings reveal important implications: Political Stability is associated with a flight-to-safety effect (Alam & Gupta, 2024) and triggers emergency fiscal/monetary responses that reshape Islamic banking operations. The coexistence of different directional effects across models indicates a conditional relationship influenced by institutional variables such as governance and rule of law (Kaufmann et al., 2023). The negative effect of Regulatory Quality reflects a regulatory paradox, where conventionally measured regulatory quality fails to accommodate digital innovation needs (Abdallah & Ben, 2023). In the MENA context, non-adaptive prudential regulations for Sharia fintech such as the lack of regulatory sandboxes and interoperability standards increase compliance costs and hinder efficiency (Boukhatem & Ben Moussa., 2018). Practically, this requires principle-based regulation and stronger regulatory capacity to align IFSB and AAOIFI standards with digital developments (IFSB, 2025).

Implications for Islamic Financial Standards

Our findings have important implications for IFSB (Islamic Financial Services Board) and AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) standards development. The regulatory paradox identified in this study suggests that current prudential standards, while effective for conventional banks, may require substantial adaptation for Islamic banks' unique risk-sharing characteristics. First, the negative association between regulatory quality and financial sustainability indicates that "one-size-fits-all" regulatory approaches may be counterproductive. IFSB's Capital Adequacy Standard (IFSB-15) and AAOIFI's Sharia Standards may need to incorporate more flexible provisions for Islamic banks' profit-loss sharing (PLS) modes of financing. Second, we recommend that standard-setting bodies consider developing separate capital adequacy frameworks for Profit-Sharing Investment Accounts (PSIA) that better reflect their risk-absorbing nature. Current risk-weighting approaches, derived from Basel frameworks, may not adequately capture the distinctive risk profile of *Mudarabah* and *Musharakah* financing. Third, the findings support stronger Sharia-based supervision that integrates *Maqāṣid al-Sharī'ah* compliance into stability assessments.

Table 5. Policy Recommendations for Enhancing Islamic Bank Sustainability in MENA

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Stakeholder	Current Challenge	Recommended Action	Expected Outcome
National Regulators	Regulatory misalignment	Develop Islamic Finance Regulatory Index (IFRI)	Reduced compliance costs and improved regulatory coherence
Central Banks	Conventional monetary tools	Introduce Sharia-compliant liquidity facilities	Improved monetary transmission
Islamic Banks	Vulnerability to political shocks	Establish political risk mitigation funds	Enhanced financial stability (improved Z-score)
International Bodies	Fragmented standards	Harmonize Sharia governance standards	Cross-border regulatory consistency
Standard Setters	Regulatory paradox	Develop Islamic finance-specific regulatory frameworks	Reduced compliance misalignment

Source: Authors' own work

Theoretical and Practical Implications

Theoretically, this study strengthens the integration of Institutional Theory (North, 1990) and Financial Intermediation Theory (Boyd & Runkle, 1993) in Islamic finance. We demonstrate that institutional quality must be disaggregated political stability and regulatory quality exert opposing effects and that conventional institutional metrics may misrepresent Islamic finance realities. Practically, our findings suggest that:

1. Policymakers should prioritize political stability while adopting balanced regulatory approaches that accommodate Sharia-compliant innovations.
2. Islamic banks should develop resilience strategies that account for institutional rather than purely macroeconomic factors.
3. Regulators should consider developing adaptive capital adequacy frameworks specifically tailored for Islamic banks' risk-sharing characteristics.

The global relevance of this study lies in the universal challenge of balancing institutional stability with financial innovation (El-Chaarani & Abraham., 2022) a challenge particularly acute in Islamic finance where ethical principles intersect with prudential requirements.

Limitations and Future Research Directions

This study has several limitations that warrant acknowledgment. First, the sample comprises only 22 Islamic banks from six MENA countries, which, while representative in asset terms (covering approximately 68% of regional Islamic banking assets), may limit generalizability to smaller Islamic banks or other regions. Second, we rely on aggregate governance indicators (WGI) that may not capture Sharia-specific regulatory aspects or enforcement quality. Third, the Z-score, while comprehensive, may not fully capture liquidity risks specific to Islamic banks. Future research should:

1. Expand geographical coverage to include Southeast Asian and African Islamic banks for comparative analysis.
2. Develop and incorporate Sharia governance indices specific to Islamic banking regulation.

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3. Employ dynamic panel models (System GMM) to address potential endogeneity between regulatory quality and bank stability.
4. Investigate non-linear relationships using threshold regression models.
5. Conduct micro-level analysis using loan portfolio data to understand transmission mechanisms from macroeconomic shocks to Islamic bank performance.

Conclusion

This study provides empirical evidence on the dual role of institutional factors in shaping Islamic bank sustainability in MENA. While political stability serves as a foundation for resilience, regulatory frameworks require careful calibration to avoid unintended consequences. The factors influencing financial sustainability in Islamic banking throughout the MENA region are empirically supported by this study. Political stability is a crucial factor in resilience and investor confidence, as evidenced by the consistent positive association with financial sustainability. Regulatory quality, on the other hand, shows a consistently negative and significant association, illustrating the regulatory paradox in which strict or non-contextual regulations can limit operational efficiency and raise compliance costs.

The study identifies a 'regulatory paradox' wherein conventional regulatory frameworks, when applied without adaptation to Islamic finance principles, may inadvertently undermine the financial sustainability of Islamic banks. This finding calls for 'smart regulation' approaches that balance prudential requirements with the unique characteristics of Sharia-compliant banking. Among macroeconomic factors, the unemployment rate shows a positive and significant effect in most models, suggesting that during periods of higher labor market uncertainty, clients may shift toward Islamic banking institutions perceived as more stable, consistent with the “flight to quality” phenomenon. Meanwhile, GDP growth and inflation do not significantly affect financial sustainability, likely due to sectoral concentration, commodity dependence, and the inherent risk-sharing mechanisms in Islamic finance that buffer short-term macroeconomic shocks.

The regulatory paradox identified also carries significant implications for international standard-setting bodies. IFSB and AAOIFI should consider revising capital adequacy and disclosure standards to better accommodate the unique risk profiles of Islamic banks, particularly regarding profit-sharing investment accounts (PSIA) and equity-based financing instruments. Theoretically, the findings reinforce the integration of Institutional Theory and Financial Intermediation Theory in explaining Islamic banks’ resilience and enrich the application of *maqāṣid al-sharī‘ah*, particularly in safeguarding wealth (*ḥifẓ al-māl*) and promoting public welfare (*maṣlaḥah*). Practically, the study highlights the need for a balanced regulatory approach that fosters innovation while ensuring stability, and for strategic resilience planning prioritizing political stability.

Future research should address the study’s temporal and geographical limitations by employing dynamic panel models to tackle endogeneity, incorporating digital governance indicators as moderating factors, conducting comparative regional analyses, and exploring micro-level loan data to better understand the transmission mechanisms of macroeconomic and institutional shocks to Islamic bank performance.

Author’s Contributions (CRediT Taxonomy)

Nani Suhartini: Conceptualization, Methodology, Investigation, Data curation, Formal analysis, Writing – original draft, Writing – review & editing.
Rifki Ismal: Supervision, Conceptualization, Validation, Writing – review & editing.

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Raditya Sukmana: Supervision, Conceptualization, Validation, Writing – review & editing.
Sulistya Rusgianto: Supervision, Methodology, Validation, Writing – review & editing.
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All authors have read and approved the final version of the manuscript.

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The authors would like to express.

Declarations

Ethical considerations

This study relies entirely on secondary, publicly available data collected from Bloomberg Terminal and World Bank databases (WDI and WGI). It did not involve any direct human participants, interviews, or private personal data. Consequently, formal ethical approval and informed consent were not required.

Use of artificial intelligence (AI)

The authors declare that no generative artificial intelligence (AI) tools or AI-assisted technologies were used in the data collection, econometric analysis, or drafting of this manuscript.

Conflict of Interest

The authors declare that they have no competing financial or non-financial interests that could have influenced the outcome or reporting of this study.

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