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Research Paper

Determinants of Islamic Banking Stability in ASEAN: The Mediating Role of Good Governance

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ABSTRACT

This study focuses on the major drivers of Islamic banking resilience in the ASEAN region, with good governance as a mediator. Good governance as a mediator between internal and external factors is understudied in the literature as a driver of stability for Islamic banking. This study addresses this gap by incorporating governance as a mediating variable in the model. This study used secondary data from 2019 to 2023 to analyze two ASEAN countries with functional Islamic banking systems and available data (Indonesia and Malaysia). Data were sourced from banks' financial reports, central banks, and the Worldwide Governance Indicators (WGI) for governance. This study used multiple regression and the Sobel test as its main methods. It was found that credit risk is important and negative for bank stability, while capital risk and the exchange rate are positive and also important. For stability, interest rates are positive but not significant. Good governance is important and positive for Islamic banking stability, but it does not mediate the impact of either credit risk or interest rates. For Islamic banking stability, capital risk and the exchange rate significantly mediate the effect of good governance. Credit risk is negative and not significant for good governance, while capital risk and the exchange rate are positive and significant. For good governance, interest rates are positive and not significant. These results show the need for an extensive governance framework for Islamic banking resilience in ASEAN.

Introduction

A country's economic system has a specific role and place for the financial system. An efficient and stable financial system is one pillar of sustainable economic growth. A volatile and inefficient financial system will disrupt economic growth. An effective financial system allows efficient allocation of economic resources to support growth in the real sector and improve public welfare. In the international dimension, the financial system's infrastructure is among the most important systems for achieving economic stability, as it helps strengthen a country's resilience to global economic shocks (Stewart et al., 2021). Over the last decade, despite several challenges, the international Islamic finance industry grew its assets by 11% in 2021 to reach US$4.5 trillion. In the last ten years, the industry has grown by 163%. The industry is expected to continue growing in the coming years and is projected to reach an asset value of US$6.7 trillion by 2027 (ICD, 2023).

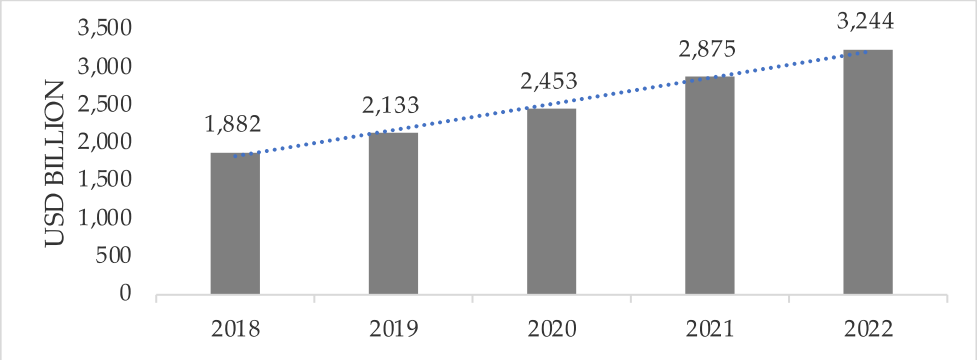

Figure 1. Global Islamic Banking Assets (2018 – 2022)

The world's Islamic banks are estimated to have US$3.24 trillion in assets in 2022 (Figure 1). Southeast Asia has seen rapid economic growth in the last few decades. Muslim finance is one sector that has experienced tremendous growth. Many countries in the region have developed Islamic banking hubs, with asset values growing each year. ASEAN governments, especially Malaysia and Indonesia, have shown robust commitment, and Islamic banking has successfully established itself as a significant global player, driven by strong asset growth (ICD, 2023). Many international financial crises in recent times have negatively affected the international financial system (Buckley et al., 2020). The Asian Financial Crisis of 1997-1998 and the Global Financial Crisis of 2007-2008 have shown the critical role of a strong banking system in sustaining a country's economic health (Basri, 2018). International crises have also shown the pitfalls of the conventional banking system, with its high exposure to usury, speculation, and uncertainty, which can adversely impact the financial system (Syarifuddin, 2022).

Due to the risks brought on by the global financial crisis, Islamic banking is becoming an increasingly attractive and stable alternative. Sharia law forms the basis of Islamic banking. It forbids interest, speculative transactions, gambling, and excessive uncertainty, thereby formalizing a financial system that is more stable in the face of external disruptions (Syarifuddin, 2022). Because it is based on real assets and avoids speculation, Islamic banking can contribute to building a more stable and sustainable financial system (Siregar, 2024). Malaysia, for example, is one of the ASEAN nations that ranks among the top 10

largest Sharia-compliant banks in Asia, holding eight of the slots on the list, as shown in Figure 2.

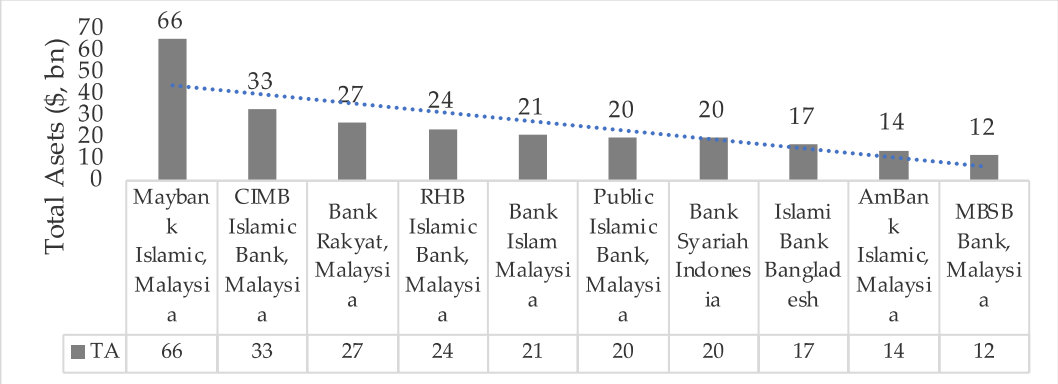

Figure 2. 10 Largest Islamic Banks in Asia Based on Total Assets

As shown in Figure 2, ASEAN nations dominate the 10 largest Islamic banks in Asia. These trends demonstrate that the overall economic resilience of Islamic financial institutions in ASEAN is increasing. Financial stability has become a priority in the banking sector, making it an exciting research topic. Stable financial conditions in the financial industry impact the overall equilibrium of the financial system. This, in turn, helps to address economic uncertainties and mitigates bankruptcies (Az-Zahra & Widarjono, 2022). Discussions around bank stability abound in financial literature. Some studies consider internal factors related to bank stability such as quality of bank assets, loan-related risks, and liquidity concerns in the context of external factors such as macroeconomic conditions, laws and rules, and level of competition in the financial markets (LP et al., 2020); (Az-Zahra & Widarjono, 2022); (Firdaus & Yuliani, 2024); (Pambuko et al., 2018); (Ozili, 2018); (Setiawan et al., 2021); (Oktaviana & Miranti, 2024); (Iqbal et al., 2024); and (Ghenimi et al., 2017). These studies provide a basis for determining the stability characteristics of Islamic banks compared with conventional banks, especially in the face of global economic shocks.

Many studies on the stability and resilience of Islamic banking institutions have examined the factors that determine their stability. This is one of the first studies to analyze the stability of Islamic banks in relation to liquidity, credit, Gross Domestic Product (GDP), inflation, government effectiveness, the rule of law, and corruption prevention, among other factors. Restrictions in the explanatory variables used still leave room for new studies to analyze other relevant variables and strengthen this research. Therefore, using macroeconomic variables such as the interest rate and exchange rate is expected to complement other approaches to analyzing the stability of Islamic financial systems. Multiple causal relationships underlie the notion of responsibility in the business sector. The first of these is good governance, which is a disclosure of stability. Good governance indicates responsibility, which is evaluated through six main dimensions. These dimensions include public participation and accountability, political stability and the absence of violence, government effectiveness, regulations, law enforcement, and the management of corruption (Iqbal et al., 2024). Good governance acts as a structural pillar for sustaining a company's operations, especially in the Sharia-compliant banking sector. Upholding good governance helps companies manage risks, avoid conflicts of interest, and uphold the principles of prudence and the law when making decisions. Furthermore, good governance

practices, including transparency, accountability, responsibility, and equity, when combined with strong governance frameworks, help to strengthen investors' confidence in a company and stimulate growth in total assets (Mahrani & Soewarno, 2018). The adoption of good governance by companies is also an important driver of a country's economic development and resilience (Azam, 2022).

Although studies have discussed the role of both internal and external factors in banking stability, further research is needed to clarify the role of good governance in this context, particularly in Islamic banking. Previous studies have focused on the direct influence of good governance on financial performance, while overlooking its role in mediating relationships. This study aims to fill this gap by treating credit risk and capital risk as internal factors and exchange rates and interest rates as external factors in Islamic banking stability. This study is the first to take this approach; as Iqbal et al. (2024) suggest, it considers other variables as relevant and includes good governance as a mediating variable that adds to other research on Islamic banking stability. By placing good governance among the determining factors of stability, the author offers, for the first time, an extension of the literature toward a more complex analysis of the stability of Islamic financial institutions. Certain studies have identified positive correlations between good governance and the financial performance of banks, although their focus is on the direct correlation between good governance and financial performance (Yuniarti et al., 2018) and (Iramani et al., 2018). Iqbal et al. (2024) emphasize the importance of good governance principles in the resilience of Islamic banks. However, no study has examined the role of good governance as a mediating variable between internal and external factors that can affect the stability of Islamic banks. One study, Iramani et al. (2018), identified bank stability as a mediating factor linking good governance to financial performance. In this case, bank stability mediated the relationship. This study therefore fills the gap by shifting the focus to good governance as a mediating factor, rather than as a direct supporting factor, in understanding the resilience of Islamic financial institutions to internal and external factors.

This study focuses on the ASEAN region and examines the role of good governance in Islamic finance in relation to the stability and resilience of Islamic financial institutions. The main question is how internal and external factors affect Islamic banks' stability through good governance practices. This study is anticipated to make significant contributions in both theory and practice. In theory, this study adds a new dimension to the existing literature in Islamic finance by identifying the strategic function of governance in building the stability and resilience of financial institutions. In practice, this study can provide regulators, bank managers, and policymakers with ideas for developing governance frameworks for Islamic banks that support efficient resilience and sustainability solutions to regional and global challenges. In practice, the results of this study can serve as a reference for regulators, bank management, and policymakers in designing effective governance strategies to strengthen the resilience and sustainability of Islamic financial institutions amid regional and global challenges.

Hypotheses Development

The theory of financial infrastructure resilience and intermediation will be the basis for this study. In financial systems, banks are intermediaries that collect funds from households and firms with surplus funds and provide those funds to sectors that need

funding. This service exists because of the information gap between owners and users of funds, which creates monitoring costs, liquidity risk, and challenges in pricing risk. Therefore, banks are essential intermediaries that meet the funding requirements of owners and users of funds (Bongomin et al., 2021). Banks are irreplaceable in the economy because they channel funds from surplus holders to funding users (Sethi & Acharya, 2020). In a stable economy, financial stability is compromised by internal factors rather than external factors such as economic recession and conflicts. Economic actors in a stable economy tend to be more exposed to risk, which can cause a financial crisis of greater magnitude. In this study, behaviours such as banking management and financial conditions are internal factors and are endogenous, while inflation and economic growth are external factors (Ullah et al., 2024).

Past empirical research has distinguished between internal and external factors related to bank stability. Internal, or fundamental, factors reside within the bank and are under management's purview. In contrast, external factors, such as inflation, exchange rates, interest rates, and government regulations, are harder to control. One important internal factor is credit risk, which can substantially affect bank stability. This risk occurs when borrowers do not repay their loans, leading to financial losses for the bank. Default risk erodes a bank's financial stability, reduces profits, depletes capital, and threatens long-term survival. To lessen this risk, banks enforce rigorous credit assessment, portfolio diversification, and creditworthiness monitoring. Effective credit risk management is crucial to the financial sustainability of a bank's operations. Männasoo and Mayes (2009) agree with financial intermediation theory that capital and credit risks are the principal factors leading to banking crises because of losses in bank income. Other studies, including Firdaus and Yuliani (2024); Oktaviana and Miranti (2024); Parmankulova et al. (2022); Ali and Puah (2018); Ferhi (2018); Trabelsi and Trad (2017); Nafla and Hammas (2016); Khasawneh (2016); and Ghenimi et al. (2017), confirm a strong link between credit risk and financial instability in banks, showing that lending on a larger scale leads to defaults. Boyacioglu et al. (2009) suggested a positive correlation between capital and financial instability in the Turkish banking sector. This finding aligns with crisis theory and runs counter to financial institution theory. They found that risk was exacerbated by reckless loan disbursements, even with considerable capital, within the banking sector. Bikker & Bos (2008) presented Profitability, Competition, and Efficiency in Bank Performance: A Theoretical and Empirical Analysis of Profitability, Competition, and Efficiency. Banks' internal factors influence profitability and operational efficiency. Intermediate theory argues that the intermediation process moderates risk. The two theories suggest that CAR positively affects bank stability because it is computed as the ratio of capital to RWA, which measures risk.

Bank stability is a combination of numerous internal and external factors. Efficient CAR management ensures banks can conduct their activities sustainably while meeting the minimum CAR requirement of 8% (Karim et al., 2010), which states that efficient banks manage credit risk to achieve stability by minimizing potential bad debts. Lotto (2019) emphasizes the role of adequate capital in facilitating the efficient use of available banking opportunities and reducing the bank's operational risks. Widarjono (2020) adds that the CAR fulfills a critical function in the stability of Islamic banks, which other scholars have also corroborated (Analia et al., 2024); (Oktaviana & Miranti, 2024); (Krisvian & Rokhim, 2021); (LP et al., 2020); (Intan Pratiwi et al., 2024); (Setiawan et al., 2021); and (Saputra et al., 2020). An adequate CAR is needed to satisfy banking operations and ensure the financial

and operational balance of Islamic banking, where the focus is on risk distribution and asset-based financing. These studies confirm the importance of adequate capital buffers in Islamic banking to achieve the required capital sufficiency and operational stability.

Both internal and external factors affect a bank's stability, with interest rates remaining controversial even among economists. Traditional views see interest rate risk as the gap between the maturity dates of a bank's assets and liabilities (BIS, 2016). Frequently, low interest rates are viewed positively, as they reduce funding costs more than the potential decrease in asset returns, thus generating positive bank equity (Akinci & Queralto, 2022). Some empirical studies state that interest margins are positively related to changes in interest rates. This is associated with the banks' market dominance in the deposit market, which is strengthened by an increase in interest rates (Borio et al., 2017). In contrast, the negative impact of interest rates on bank solvency should not be ignored. Although interest margins grow, a major competitive disadvantage of high interest rates is the mining of long-term bank assets. Eventually, if interest rates exceed a threshold, banks become insolvent and may trigger a financial crisis. This threshold may be determined by the functioning of the liquidity system, where the banking system's short-term assets increase its vulnerability to interest rate risk. Prior to the Global Financial Crisis, prevailing interest rate margin gaps in US data indicated that an interest rate at or below 0.32% would result in a banking crisis. Nevertheless, within the context of Islamic banking, several studies (Amaroh et al., 2024); (Analia et al., 2024); (Firdaus & Yuliani, 2024); (Syapriatama & Pratiwi, 2021); and (Dwinanda & Sulistyowati, 2021) determined that interest rate levels did not impact bank stability over the long term, which goes against the studies on conventional banks that indicate the role of interest rates in banking instability (Porcellacchia, 2022); (Pambuko et al., 2018); and (Köhler, 2015).

Exchange rate changes affect all financial institutions, including those operating under Islamic finance. These changes can have positive or negative effects, depending on exchange-rate stability and the financial institution's risk-exposure management. A currency with a stable or improved value strengthens Islamic banks' resilience, signalling a developed economy with improved investor confidence and a better business environment. Exchange rate stability in the context of Islamic banking expands both bank capital and liquidity. This is consistent with Interest Rate Parity (IRP) theory, which states that exchange-rate equilibrium balances interest rates between countries, attracts capital inflows, and promotes financial system stability. Pambuko et al. (2018) and Widarjono (2020) provide clear evidence to support the argument that exchange rate stability improves liquidity and banking sector competitiveness. Islamic banks' resilience can decline due to exchange rate depreciation. A currency that loses value increases import costs, fuels inflation, reduces purchasing power, and increases non-performing loans. Currency volatility increases uncertainty, financial system instability, and decreased investor confidence. Widarjono (2020), Pambuko et al. (2018), and Salami & Adeyemi (2015) show that high currency volatility creates banking instability, particularly in unstable economies.

A recent study shows that good governance is a key consideration when assessing banking system stability. Much of the research done in this area is still in its infancy. Good governance focuses on greater participation and accountability. It is closely linked to political stability and the absence of violence, the quality of regulations and legal frameworks and their implementation, administrative efficiency, corruption management, and overall governance quality. An efficient governance framework provides a stable and

predictable business environment and strengthens banking activities. An efficient regulatory framework and open government institutions strengthen the financial sector and improve the quality of banks' assets and their financial performance. In addition, a stable political environment and the absence of violent conflict positively affect the development of a strong banking sector, enhancing the resilience and sustainability of the financial system. In 1996, the World Bank's Development Research Group dedicated its efforts to advancing developing countries and Macroeconomics. These efforts culminated in the development of six essential indicators of governance quality across different countries. These include community participation and transparency; the stability of the political process and efforts to eliminate violence; the quality of regulations and their enforcement; the management of corruption; and government efficiency. According to a World Bank Report by AlBassam (2013), effective governance and political stability have a positive and significant effect on the development of a social economy.

Well-run governments are vital for funding organizations that lend or grant money, as they can stimulate economic growth. Evans & Rauch (1999) found that bureaucracy plays a significant role in economic development, while Defond & Hung (2004) state that good governance encourages investor confidence, spurs investment, and helps banks remain stable. This idea is consistent with Ali & Puah (2018), who suggest that banking stability and regulation need to be studied in detail and that this can be done using econometric methods.

Conceptual Framework

This study attempts to follow in the footsteps of Iqbal et al. (2024), Oktaviana & Miranti (2024), Khasawneh (2016), Dwinanda & Sulistyowati (2021), Ghenimi et al. (2017), Ferhi (2018), Yuniarti et al. (2018), Ozili (2018), Az-Zahra & Widarjono (2022), Widarjono (2020), Setiawan et al. (2021), Law & Ridhwan (2022), Mamatzakis et al. (2023), Adiputri & Sulung (2019), and Iramani et al. (2018). This study also aims to develop an extensive theoretical model to understand the various factors and aspects that influence bank resilience. The factors that influence bank stability can be divided into two main categories: internal factors that are present and managed by the bank's leadership, and external factors influenced by forces beyond the bank's control. This study also analyses the impact of good governance as an intervening factor that can influence the correlation between internal and external factors and bank stability. In this instance, good governance can act as an intervening factor which can either facilitate or obstruct the influence of these factors on resilience. The basic model of this study identifies the key components of bank stability, as illustrated in Figure 3. Previous studies have documented various findings related to the internal and external factors of Islamic bank resilience. With respect to its influence on the stability of Islamic banking in Asia, the hypothesis below is postulated:

H_1: Credit risk has a significant effect on good governance.
H_2: Capital risk strongly correlates with good governance.
H_3: Exchange rate risk correlates with good governance.
H_4: Good governance correlates with interest rate risk.
H_5: Credit risk correlates directly with the stability of Islamic banks.
H_6: Capital risk correlates with the stability of Islamic banks.
H_7: Exchange rate risk correlates with the stability of Islamic banks.

H8: Interest rate risk is positively related to the stability of Islamic banks.
H9: Good governance is positively related to the stability of Islamic banks.
H10: Good governance is directly related to credit risk, which impacts the stability of Islamic banks.
H11: Good governance is directly related to capital risk, which affects the stability of Islamic banks.
H12: Good governance is directly related to the exchange rate, which impacts the stability of Islamic banks.
H13: Good governance is directly related to interest rate risk, which affects the stability of Islamic banks.

Method

This study uses secondary data sources. Specifically, this study uses panel data. Panel data combines cross-sectional and time-series data in a single unit of analysis. For example, time series data is collected at multiple points in time to ensure that the data is both precise and extensive.

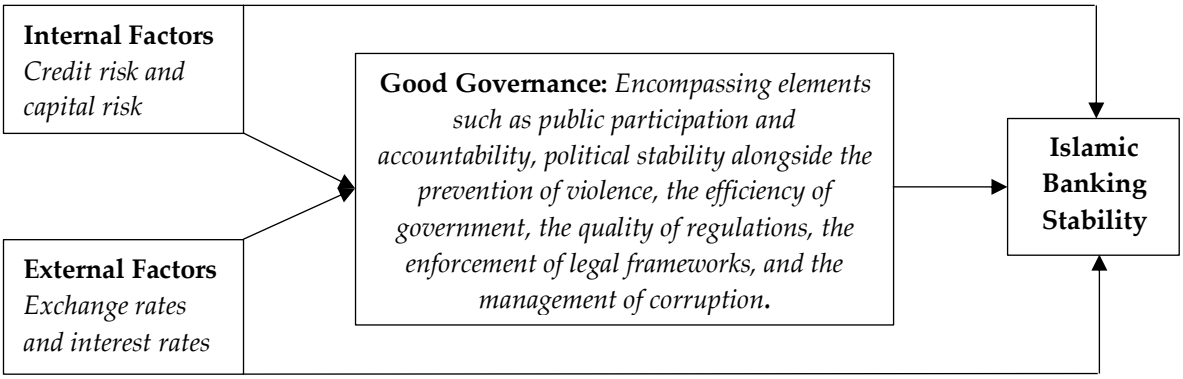

Figure 3. Conceptual Framework

This study analyzed data for five years, from 2019 to 2023. The data were cross-sectional and were gathered from multiple research subjects in two ASEAN countries, Indonesia and Malaysia. Indonesia and Malaysia were selected because they have their own Islamic banking systems and adequate, pertinent data for the study. The main data sources were each bank's financial reports and the official websites of both countries' central banks, which provide information on the financial conditions and stability of Islamic banks. At the same time, data on good governance were sourced from the Worldwide Governance Indicators (WGI), which has governance indicators for six main topics: Community participation and transparency, the state of the political environment and efforts to address violence, the quality of the government and regulations, and the enforcement of legal systems and the management of corruption.

Model Development

This manuscript aims to analyze the relationship between predictors and the outcome over a given timeframe, using a multiple regression model with panel data. The adopted

model controls for omitted, unobservable individual heterogeneity and integrates time-series and cross-sectional data. To select the best panel data regression model and compare estimation methods, the author of this manuscript performed a set of tests for model specification. These included the Chow test, the Hausman test and the Lagrange Multiplier test for the characteristics of the panel data. The results of the three tests will help select the most appropriate multiple regression model to assess the relationship between the variables in this study.

$$Y_{it} = \alpha + \beta_1 X_{1it} + \beta_2 X_{2it} + \cdots + \beta_n X_{nit} + e_{it}$$

Variable Measurement

This research uses panel data multiple regression to examine the effect of economic factors on the stability of Islamic banking. Panel data multiple regression is used because it allows variables to vary across time and individuals, resulting in better outcomes than typical cross-sectional or time-series regression. The author uses Islamic Banking Stability (Stability), Credit Risk (NPF), Capital Risk (CAR), Exchange Rate (ER), and Interest Rate (IR) as predictors and Good Governance (GGV) as a mediating variable. To examine the mediating effects, the author will use a Sobel test. In this test, the importance of the mediating effect is examined by assessing the correlation between the predictors and the mediating effect, as well as the correlation between the mediating effect and the outcome variable. The author is interested in the Sobel test results to assess whether a mediation effect exists in the relationship examined, and to use a t-test and t-table to assess the mediating effect. This research focuses on the mechanisms that affect Islamic banking stability.

Table 1. Variable Description

Name	Mark	Indicator	References
Islamic Banking Stability	Stability	The Z-Score for stability is determined by adding the asset returns to the ratio of capital adequacy, and the resulting number is then divided by the standard deviation of the returns on assets.	Iqbal et al. (2024); Oktaviana & Miranti (2024); Az-Zahra & Widarjono (2022); Widarjono (2020); and Kaharuddin & Yusuf (2022)
Credit Risk	NPF	Non-Performing Financing	Ghenimi et al. (2017); Dwinanda & Sulistyowati (2021); Setiawan et al. (2021); and Parmankulova et al. (2022)
Capital Risk	CAR	Capital Adequacy Ratio	Ozili (2018); Ghenimi et al. (2017); Oktaviana & Miranti (2024); and Saputra et al. (2020);
Exchange Rate	ER	Authorized rate of exchange (units of local currency for each US dollar, average over the period)	Iqbal et al. (2024); Widarjono (2020); and Pambuko et al. (2018)
Interest Rate	IR	Interest rate percentage value	World Development Indicators (WDI); Iqbal et al. (2024); Analia et

Name	Mark	Indicator	References
			al. (2024); and Firdaus & Yuliani (2024)
Good Governance	GGV	The Good Governance Index is determined by calculating the means of six essential indicators: community involvement and transparency, the stability of the political environment along with efforts to avert violence, the efficiency of government, the quality of regulations, the enforcement of legal frameworks, and the management of corruption. These indicators are aggregated into one index per country for the period 2019–2023.	Worldwide Governance Indicators (WGI)

Source: Data Processed by the Author, 2024

$$Stability_{it} = \alpha + \beta_1 NPF_{1it} + \beta_2 CAR_{2it} + \beta_3 ER_{3it} + \beta_4 IR_{4it} + \beta_5 GGV_{5it} + e_{it}$$

Results

Descriptive statistics provide an initial overview of the characteristics of the data in this study. It is important to understand the distribution, general trend, and spread of data from each variable under study. Table 2 displays the sample size, mean, median, standard deviation, minimum, and maximum values for the variables of Islamic banking stability (Stability), credit risk (NPF), capital risk (CAR), exchange rate (ER), interest rate (IR), and good governance (GGV). These results show sufficient variation between observations, indicating that the data has sufficient diversity to be analyzed further in the regression model.

Table 2. Descriptive Statistics

Variable	Obs.	Mean	Median	Max.	Min.	Sd.
Stability	380	9.25	6.60	61.05	.06	6.44
NPF	380	2.26	1.59	10.92	.06	1.82
CAR	380	21.65	15.89	149.68	10.97	14.51
ER	380	9.73	14.10	15.63	4.07	5.18
IR	380	3.57	3.50	6.00	1.72	1.39
GGV	380	28.84	26.24	33.36	24.08	3.87

Source: Data Processed by the Author, 2024

The description in these results is meant to show the basic characteristics of the data in this survey. To understand the data, consider the distribution, overall shape, and spacing of each variable. In Table 2, the number of samples, the arithmetic mean, the median, the standard deviation, the minimum, and the maximum for the variables of Islamic banking stability (Stability), credit risk (NPF), capital risk (CAR), exchange rate (ER), interest rate

(IR), and good governance (GGV) are given. The comparison of observations shows sufficient variation. This indicates the data has sufficient variety for analysis in the regression framework. Before carrying out the regression analysis, a correlation test among the predictor variables was conducted to see whether relationships were so strong that they could lead to multicollinearity. Table 3 displays the results of the correlation assessment. It shows no signs of multicollinearity among the predictor variables in the regression model. This means that each predictor variable has a relationship that is not too strong with the others. Therefore, no superfluous information can affect the accuracy of the regression coefficient estimates. This means the regression model is better specified, and the results of the analysis provide a more valid description of the relationships among the different factors.

Table 3. Variable Correlation Matrix

	Stability	NPF	CAR	ER	IR	GGV
Stability	1.0000					
NPF	0.0991	1.0000				
CAR	0.7522	0.0124	1.0000			
ER	0.5477	0.3703	0.5516	1.0000		
IR	0.4145	0.2579	0.4425	0.8005	1.0000	
GGV	-0.4943	-0.3811	-0.4961	-0.7722	-0.7922	1.0000

Source: Data Processed by the Author, 2024

Having checked for multicollinearity, regression analysis was performed to determine the impact of each predictor variable on the outcome variable. Each predictor variable's impact on the outcome variable is indicated by its coefficient, which shows the direction and magnitude of the effect. Meanwhile, the p-value determines the relevance of the predictor variable in the model. If the p-value is ≤ 0.05, the variable has a significant impact on the outcome variable. Furthermore, Prob (F-Statistic) indicates the model's significance. Table 4 presents the regression results on the relationship between NPF, CAR, ER, and IR and good governance (GGV).

Table 4. Partial and Simultaneous Test of NPF, CAR, ER, IR on GGV

Variable	Coefficient	Std. Error	t-Statistic	Prob.
NPF	-0.0009	0.0010	-0.8679	0.3860
CAR	0.0005	0.0001	3.7531	0.0002
ER	-0.0264	0.0006	-42.589	0.0000
IR	0.0017	0.0020	0.8210	0.4122
Prob (F-Stat)		0.0000		

Source: Data Processed by the Author, 2024

Table 4 shows that capital risk and forex market risk have a greater impact on good governance than credit risk and interest rate risk. These results are supported by Abou-El-Sood (2017), Chitan (2012), and Leung & Horwitz (2010). Good governance is largely impacted when credit risk and interest rate risk are present, as evidenced by the probability value being greater than 0.05. Although they affect banks' risk management, in the context of this study, their impact on good governance is weak. In contrast, good governance is

significantly affected when credit risk, capital risk, forex risk, and interest rate risk coexist. This implies that good governance in the ASEAN region is shaped by both internal and external factors that determine its extent and quality in terms of stability and transparency.

Table 5. Partial and Simultaneous Test of NPF, CAR, ER, IR, GGV on Stability

Variable	Coefficient	Std. Error	t-Statistic	Prob.
NPF	-0.0678	0.0130	5.1976	0.0000
CAR	0.0246	0.0017	14.5971	0.0000
ER	0.0614	0.0159	3.8513	0.0001
IR	0.0281	0.0204	-1.3767	0.1694
GGV	1.5394	0.5282	2.9144	0.0038
Prob (F-Stat)		0.0000		

Source: Data Processed by the Author, 2024

The outcomes of the analysis presented in Table 5 show that credit risk, capital risk, exchange rates, and good governance influence the resilience of Islamic banks at a significant level (p-value < 0.05). The impact of interest rates on the resilience of Islamic banks is insignificant (p-value>0.05). It is reasonable to claim that the variables in the model are highly significant, as shown by a very low Prob (F-Statistic) of 0.0000. This indicates that all predictor variables collectively affect the dependent variable, namely Islamic banking stability. The effects of good governance as a mediating variable on the risk factors and Islamic banking stability were further tested through mediation analysis. The goal of the present analysis is to confirm the presence of an indirect effect to determine whether the mediating variable is present. The Sobel test is used to test this mediation effect. The test compares the t-count with the critical value in a t-table to examine whether the mediating variable is present. Consequently, if the t-count is greater than the critical t-value, then the variable has been confirmed to be present; otherwise, it is not present.

Table 6. Mediation Test Results

Mediating Effect	T-Test	T-Table
NPF → GGV → Stability	-0.83	1.97
CAR → GGV → Stability	2.30	
ER → GGV → Stability	-2.91	
IR → GGV → Stability	0.79	

Source: Data Processed by the Author, 2024

Table 6 presents the results of the mediation test for the role of good governance (GGV) in mediating the relationship between risk factors and Islamic banking stability. In the path NPF → GGV → Stability, good governance does not mediate the relationship between credit risk and banking stability. This is supported by the fact that the t-count (-0.83) is less than the critical value of 1.97. In contrast, for the path CAR → GGV → Stability, the t-count (2.30) exceeds the t-table critical value (1.97), so good governance mediates the relationship between capital risk and banking stability. The path ER → GGV → Stability is also valid, with a t-count of -2.91, which exceeds the critical t-table value, so good governance mediates the relationship between the exchange rate and banking stability. The

path IR → GGV → Stability does not show a significant effect because the t-count value is less than the critical value, i.e., 0.79.

In sum, the results of this study will help the local and international banking industry to understand the correlation and relationship between governance, good/bad management, and Islamic banking and its stability. Regarding the regression analysis, bad governance was attributed to credit risk and interest rate, while good governance was attributed to capital risk and the exchange rate. The study also attributed credit risk, capital risk, the exchange rate, and good governance to bank stability, and the interest rate to the opposite. Additionally, good governance is crucial for Islamic banking stability, particularly in ASEAN, especially with respect to the impact of exchange and capital risks. The study concluded that the effect of credit risk and interest rates on bank stability is likely to occur through other channels. Overall, the study's outcomes will aid understanding of good governance in banking stability, especially in Islamic banking in the ASEAN region.

Discussion

This study identified the negative and significant influence of credit risk on the stability of Islamic banking in ASEAN. It shows that elevated credit risk negatively affects bank financial stability and impacts profitability. However, implementing firm and effective risk management through strict credit assessment, diversification of the financing portfolio, and active credit control improves a bank's overall stability. This negative correlation suggests that as non-performing financing increases, bank stability declines. This is because high levels of non-performing financing occur when customers do not fulfil their obligations. Thus, the bank is exposed to financing risk, financing income declines, and liquidity declines, which aggravates bank risk. The findings are in line with (Iqbal et al., 2024); (Oktaviana & Miranti, 2024); (Ali & Puah, 2018); (Amara & Mabrouki, 2019); (Ferhi, 2018); (Setiawan et al., 2021); (Ghenimi et al., 2017); (Dwinanda & Sulistyowati, 2021); (Parmankulova et al., 2022); and (Nafla & Hammas, 2016). The relationship between capital risk and Islamic banking stability in ASEAN countries is positive and statistically significant, suggesting that better capital management increases stability in Islamic banking conditions. While capital plays an important role in bank management, it plays an even stronger role in banking. First, it builds banks' resilience against financial market volatility. Second, capital protects banks from going bankrupt. Banks that manage their capital well have the financial capacity to address financial challenges. In line with Trade-off theory, if a bank has adequate capital, it can increase liquidity and financial stability while minimizing the risk of bankruptcy. These assertions have been confirmed by the studies of Analia et al. (2024), Oktaviana and Miranti (2024), Ghenimi et al. (2017), Krisvian and Rokhim (2021), LP et al. (2020), Intan Pratiwi et al. (2024), Setiawan et al. (2021) and Löhner (2015).

In Islamic banking, the ASEAN region shows that the exchange rate has positive and significant effects on stability in the region. Evidently, the stronger and more stable the exchange rate, the more stable the Islamic banks are. Although the exchange rate system is a macroeconomic subsystem that determines and influences many elements of the economy, including inflation and interest rates, a stable exchange rate enhances confidence among investors and clients. It improves the financial system's business climate. This shows the confidence boost that a country's stable currency and exchange rate provide to the economy and attract foreign investment. This boost gives banks the strength and capacity to finance

more. In line with IRP theory, a balanced exchange rate reduces interest-rate disparities, attracts foreign investment, and strengthens the stability of a country's financial system. These views are supported by Pambuko et al. (2018) and Widarjono (2020), who indicated that exchange-rate fluctuations have a positive effect on the stability of Islamic banks. An analysis of interest rates on stability shows that interest rates have a weak and insignificant effect. Although interest rates and stability are positively related, the effect is still not strong enough to be an important factor affecting the stability of Islamic Banking. The insignificance of the relationship suggests that Islamic banks in ASEAN have sufficient stability in the event of sharp changes in interest rates. This is attributable to the main elements of Islamic financial assets, which are generally more stable and less reactive to changes in interest rates than conventional banking system loans. This can be justified by (Analia et al., 2024); (Firdaus & Yuliani, 2024); (Law & Ridhwan, 2022) ; (Amaroh et al., 2024); and (Syapriatama & Pratiwi, 2021), which state that the stability of Islamic banks will be unaffected in the long term by a change in interest rates. These findings contrast with studies by Pambuko et al. (2018) and Porcellacchia (2022), which linked interest rates to banking instability in conventional banks.

Interest rates have little effect on Islamic banking stability due to good governance. Regarding the impact of macroeconomic and monetary policies, interest rates do not affect Islamic banking stability under good governance. In a banking system based on profit sharing and the exclusion of interest, the interest rate in the conventional banking system has little effect on stability and profitability (Nouman et al., 2022; Riani, 2025; Rohimah & Oktaviana, 2024). Furthermore, in the context of the correlation between interest rates and Islamic banking, good governance is not as important as a mediating variable (Iqbal et al., 2022; Syahdani et al., 2026). Therefore, more studies are needed to identify other variables that have a greater influence on the stability of Islamic banks in the ASEAN region. These findings, including this current study, help construct frameworks for analyzing the elements of stability of Islamic financial institutions at the regional level. They can also help banking authorities, professionals, and academics develop useful policies and strategies for improving the stability of the Islamic finance industry. The role of good governance as a mediating variable indicates its importance in sustaining the stability of the Islamic finance industry amid changing economic conditions. This study is expected to inform the development of Islamic banking regulations to preserve the long-term existence and competitiveness of the Islamic banking industry.

The overall findings suggest that Islamic banking stability in ASEAN is best understood as the outcome of an interaction between internal financial capacity, macroeconomic conditions, and the quality of the institutional environment rather than as the consequence of any single risk factor (Kurnia et al., 2026; Nailah & Rusydiana, 2020). The significant negative association between credit risk and stability confirms that weaknesses in financing quality remain a fundamental source of vulnerability even within a Sharia-compliant banking model (Othman et al., 2018). By contrast, the positive effects of capital adequacy and exchange-rate conditions indicate that resilience is also strongly connected to the capacity of banks and the broader financial environment to absorb shocks. Importantly, the significance of good governance adds an institutional dimension to this explanation. Governance is not merely an administrative requirement but represents an enabling environment through which prudential practices, regulatory quality, accountability, and legal enforcement can support banking resilience. This extends the

financial intermediation perspective by suggesting that the effectiveness of banks' internal risk-management mechanisms is partly embedded within the institutional structures in which they operate. Thus, Islamic banking stability should be viewed as a multidimensional phenomenon in which financial soundness and institutional quality reinforce one another.

The mediation results provide an important refinement of this interpretation because good governance does not uniformly transmit the effects of all risk factors to banking stability. Its mediating role is significant for capital risk and exchange-rate conditions, but not for credit risk or interest rates. This distinction suggests that governance operates more effectively where banks' resilience depends on institutional coordination, capital discipline, and responses to broader financial conditions. Capital adequacy, for example, can provide a buffer against adverse developments, but the effectiveness of that buffer depends on how prudential standards are implemented, monitored, and enforced. Similarly, exchange-rate conditions are partly transmitted through the quality of the institutional environment because investor confidence, regulatory predictability, and macro-financial coordination influence how external shocks are absorbed. The absence of mediation for credit risk is equally theoretically meaningful. Credit risk appears to influence stability more directly through financing quality, borrower repayment capacity, and asset deterioration, areas that cannot necessarily be resolved through improvements in broader governance indicators alone. Likewise, the insignificant interest-rate relationship and the absence of mediation suggest that conventional monetary conditions may have a relatively limited direct or governance-mediated role in Islamic banking stability. These findings therefore caution against treating governance as a universal transmission mechanism and instead position it as a contingent institutional mechanism whose relevance depends on the nature of the underlying risk.

From a practical perspective, the findings imply that Islamic banks should move beyond treating governance and risk management as separate organizational functions. The significant relationships among capital risk, exchange rates, governance, and stability indicate the value of integrating governance considerations into strategic risk-management systems. Bank management should therefore ensure that capital planning, financing decisions, stress testing, and external-risk assessment are supported by clear accountability structures, effective internal controls, regulatory compliance, and transparent decision-making. At the same time, the significant negative effect of credit risk demonstrates that governance improvements cannot substitute for effective financing-risk management. Islamic banks still require rigorous credit assessment, portfolio diversification, continuous monitoring of non-performing financing, and timely corrective action. The limited role of interest rates also suggests that managers should avoid relying excessively on conventional interest-rate movements as a primary indicator of Islamic banking vulnerability and instead focus on the transmission mechanisms that are more directly relevant to their balance sheets and financing structures. For regulators, the results support a more integrated supervisory approach in which capital adequacy, asset quality, macroeconomic exposure, and governance quality are evaluated together. Such an approach would be particularly relevant in ASEAN, where Islamic banking systems operate within increasingly interconnected financial and economic environments.

At the policy level, the findings support the development of a comprehensive governance framework for Islamic banking resilience rather than policies that focus exclusively on minimum financial ratios. The positive and significant role of good

governance indicates that public accountability, political stability, government effectiveness, regulatory quality, rule of law, and corruption control constitute an important institutional foundation for financial stability. Policymakers in Indonesia and Malaysia can consequently strengthen Islamic banking resilience by improving the consistency and enforcement of prudential regulation, enhancing institutional transparency, and ensuring that supervisory authorities possess sufficient capacity to identify emerging risks. The mediation of capital risk and exchange-rate conditions further indicates that governance policy should be coordinated with macroprudential and monetary frameworks, allowing regulatory institutions to respond more effectively to external shocks while maintaining adequate capital buffers. At the same time, the non-mediation of credit risk highlights the need for targeted policies addressing asset quality rather than assuming that improvements in governance will automatically reduce financing problems. More broadly, the findings suggest that ASEAN Islamic banking resilience requires coordination between bank-level governance and country-level institutional quality. Such coordination can strengthen confidence in Islamic financial institutions, improve their capacity to withstand economic disruptions, and support the longer-term sustainability and competitiveness of Islamic finance in the region.

Conclusion

This research shows how multiple internal and external factors affect the stability of Islamic banks in ASEAN. Internally, elements such as credit and capital risk are important. Externally, fluctuating exchange and interest rates affect banks. Additionally, the presence of good governance, where the public can participate and hold the government accountable, as well as political stability, the prevention of violence, efficient government, quality regulation and the rule of law, along with efforts to control corruption, affect the stability of a system. The research supports the development of an Islamic finance-based financial stability framework. For regulators and market participants, the study offers useful suggestions for implementing comprehensive risk management, strengthening governance practices, and enhancing the ability to adapt to changes in the macro economy.

Limitation of this current study should be acknowledged. The first is related to data coverage. Because of this limitation, the results apply only to a specific time period and countries in the ASEAN region; therefore, they may not be generalizable to a wider region or context. The second relates to the use of a purely quantitative approach. This has obvious constraints, such as being unable to capture the intricacies and dimensions of certain qualitative aspects, particularly governance, which may be culture-bound and policy-influenced. For these reasons, future studies should focus on broader scope and depth of coverage and include other variables, such as risk management, which plays a significant role in sustaining the stability of Islamic banking. With reference to risk management, future studies may utilise CRM (Common Risk Management) and SRM (Specific Risk Management) in Islamic banking to better address uncertainty and anticipate regulatory changes in the environment most likely to affect the stability of Islamic banks.

Authors' Declaration

The authors made substantial contributions to the conception and design of the study. The authors took responsibility for data analysis, interpretation and discussion of results. The authors read and approved the final manuscript.

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