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A MODERATED MEDIATION ANALYSIS OF ISLAMIC BANK STABILITY IN ASIAN OIC COUNTRIES

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ABSTRACT

Purpose: This study investigates the relationship between asset diversification and Islamic bank stability by incorporating profitability as a mediating variable and managerial ownership as a moderating variable. The study aims to determine whether diversification contributes to financial resilience and whether internal governance mechanisms reinforce this effect.

Methodology/approach: Using panel data from Islamic banks in OIC Asian countries during 2020–2024, the analysis applies Hayes' PROCESS Model 15, allowing the simultaneous examination of mediation and moderation effects within a single analytical framework.

Findings: The results show that managerial ownership plays a decisive role in influencing Islamic bank stability, with evidence pointing to a destabilizing governance effect. Conversely, asset diversification and profitability do not demonstrate a meaningful relationship with stability. Additional analysis indicates that profitability does not mediate the diversification stability nexus, and managerial ownership does not condition these relationships. These findings highlight the dominant role of governance incentives over diversification strategies in explaining stability outcomes among Islamic banks.

Practical implications: The study enriches the agency–governance discourse in Islamic finance and offers policy



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insights for strengthening the long-term resilience of Islamic banks.

Originality/value: The research introduces a moderated mediation framework integrating diversification, profitability, and managerial ownership using Hayes' PROCESS Model 15 in the context of OIC Asian Islamic banks.

Keywords: Asset Diversification; Bank Stability; Islamic Banking; Managerial Ownership; Profitability.

ABSTRAK

Tujuan penelitian: Penelitian ini bertujuan untuk menganalisis pengaruh diversifikasi aset terhadap stabilitas bank Islam dengan mempertimbangkan peran profitabilitas sebagai variabel mediasi dan kepemilikan manajerial sebagai variabel moderasi.

Metode/pendekatan: Data panel diperoleh dari bank-bank Islam di negara-negara OKI kawasan Asia selama periode 2020–2024 dan dianalisis menggunakan conditional process analysis melalui Model PROCESS Hayes 15 untuk menguji hubungan langsung, mediasi, dan moderasi secara simultan.

Hasil: Hasil penelitian menunjukkan bahwa kepemilikan manajerial memainkan peran yang menentukan dalam memengaruhi stabilitas bank Islam, dengan bukti yang mengarah pada efek tata kelola yang bersifat melemahkan stabilitas. Sebaliknya, diversifikasi aset dan profitabilitas tidak menunjukkan hubungan yang bermakna terhadap stabilitas. Analisis lanjutan mengindikasikan bahwa profitabilitas tidak berperan sebagai mediator dalam hubungan antara diversifikasi dan stabilitas, serta kepemilikan manajerial tidak bertindak sebagai faktor yang memoderasi hubungan tersebut. Temuan ini menegaskan bahwa insentif tata kelola memiliki peran yang lebih dominan dibandingkan strategi diversifikasi dalam menjelaskan tingkat stabilitas bank Islam.

Implikasi praktik: Penelitian ini memperkaya perspektif agen tata kelola Islam dan memberikan implikasi kebijakan bagi regulator dan praktisi dalam memperkuat stabilitas sektor keuangan Islam.

Orisinalitas/kebaharuan: Penelitian ini menawarkan kerangka moderated mediation yang mengintegrasikan diversifikasi aset, profitabilitas, dan kepemilikan manajerial untuk menjelaskan stabilitas bank Islam di

negara OKI Asia menggunakan Model PROCESS 15 Hayes.

Kata kunci: Diversifikasi Aset; Kepemilikan Manajerial; Profitabilitas; Perbankan Islam; Stabilitas Bank.

INTRODUCTION

The Islamic banking industry has experienced significant growth over the past few decades, positioning itself as a vital component of the global financial system. According to the Islamic Financial Services Board (IFSB, 2024), the total assets of the Islamic banking industry reached USD 2.8 trillion, marking a steady increase despite global economic volatility. However, this aggregate growth masks a concerning trend in the Asian region. While assets have expanded, recent data indicates a volatility in financial stability metrics (Z-Scores) among Asian OIC banks that diverges from the trajectory seen in the Gulf Cooperation Council (GCC) region. This phenomenon raises critical questions about the resilience of Islamic banks in developing Asian markets facing unique structural constraints.

The stability of Islamic banks is paramount, not only for the financial system but also for public confidence in Sharia compliant institutions. Theoretical literature suggests that stability is driven by asset diversification and profitability costs (Berger et al., 2010). Yet, a critical data gap exists in the current literature. The majority of empirical studies utilize data heavily concentrated on MENA and GCC countries (Sahyouni & Wang, 2019) leaving the specific dynamics of Asian OIC countries such as Indonesia, Malaysia, and Pakistan under-researched. Unlike the oil-based economies of the GCC, Asian OIC banks operate in diverse regulatory environments with different market deepening levels. Therefore, relying on generalized data from the MENA region fails to capture the specific risks and governance challenges faced by Asian Islamic banks.

Banking stability is a fundamental pillar of financial system resilience and long-term economic sustainability. The global financial crisis of 2007–2008 and the COVID-19 pandemic demonstrated how vulnerabilities in the banking sector can trigger systemic disruptions, erode public confidence, and weaken both monetary transmission and real-sector performance (Battiston et al., 2021; Bilgin et al., 2021). In recent years, global economic uncertainty has intensified due to inflationary pressures, geopolitical conflicts, supply-chain disruptions, and accelerated digitalization, amplifying cross-border contagion effects within the financial system (Al-Shboul et al., 2020; Anginer et al., 2018). These developments reaffirm that maintaining banking stability is not only a domestic policy priority but also a global imperative.

Within the Islamic banking landscape, stability becomes an even more complex issue. Although Islamic banks operate under asset-backed financing and risk-sharing principles that theoretically enhance resilience (Bitar et al., 2021), empirical findings show that they remain exposed to concentration risk, limited diversification opportunities, and governance challenges (Miah & Uddin, 2017; Safiullah, 2021). The Asian OIC region representing the largest share of global Islamic banking assets exhibits considerable variation in regulatory quality, managerial capacity, and governance effectiveness, leading to heterogeneous stability outcomes across countries and institutions.

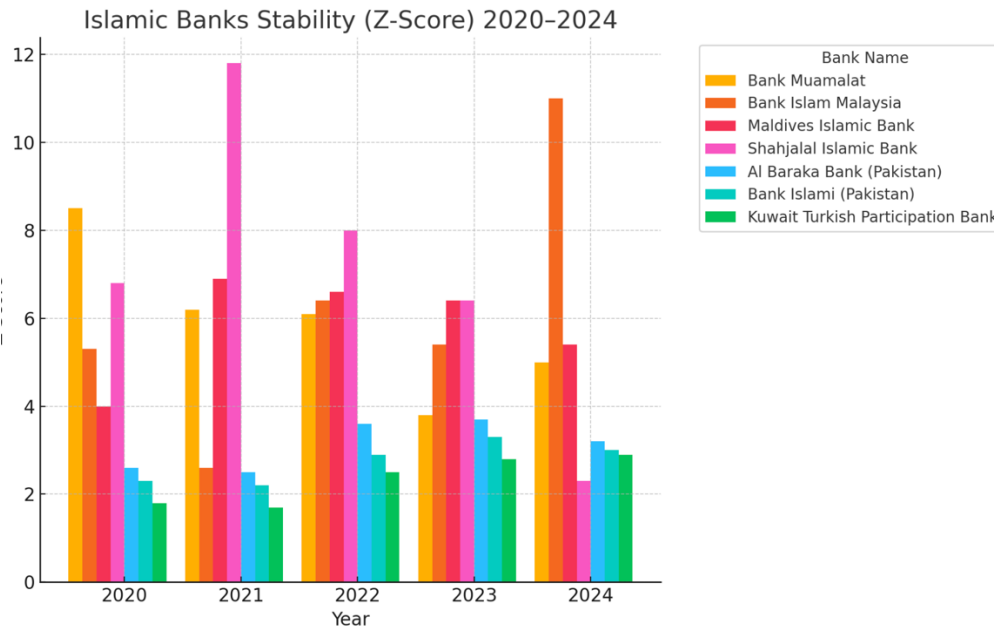


Figure 1.
Bank-Level
Z-Score

Figure 1 illustrates the variation in stability scores (Z-Score) across seven Islamic banks in Asia during the 2020–2024 period. A high degree of heterogeneity is observed: Bank Islam Malaysia experienced a sharp rise in stability in 2024, while Shahjalal Islamic Bank recorded a significant decline. Other banks such as Maldives Islamic Bank and Bank Muamalat Indonesia displayed more moderate patterns. This variation reflects cross-country differences in ownership structure, risk management strategies, and the effectiveness of Sharia governance implementation.

One of the most widely studied determinants of bank stability is asset diversification. According to portfolio theory [Markowitz \(1952\)](#), diversification reduces concentration risk, expands income sources, and enhances long-term resilience. However, previous empirical studies have produced mixed results. Some found a positive relationship between diversification and stability ([Abuzayed et al., 2018](#); [Paltrinieri et al., 2021](#); [Adem, 2023](#)), while others highlighted potential negative effects due to over-diversification, which can increase complexity and coordination costs ([Berger et al., 2010](#); [Kim et al., 2020](#)). This inconsistency highlights a second gap: the lack of clarity regarding the transmission mechanism. Specifically, there is limited empirical evidence explaining how profitability mediates the relationship between diversification and stability in the context of dual-governance (Sharia and Board) systems characteristic of Asian markets. Without understanding this mechanism, policymakers cannot formulate effective diversification guidelines.

Furthermore, profitability (ROA) is often conceptualized as a mediating mechanism bridging the link between diversification and stability. Theoretically, a well-diversified asset portfolio can enhance earnings, strengthen capitalization, and reduce earnings volatility ([Nguyen, 2018](#); [Viverita et al., 2023](#)). Yet, empirical evidence shows that higher profitability does not always translate into greater stability. Under certain conditions, high profits may encourage excessive risk-taking, particularly when management focuses on short-term gains ([Paltrinieri et al., 2021](#); [Mollah et al., 2019](#)).

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Another critical dimension is ownership structure, especially managerial ownership. Based on agency theory [Jensen & Meckling \(1976\)](#), share ownership by management can align the interests of principals and agents, thereby improving monitoring and efficiency. However, more recent literature reveals a paradox: when managerial ownership becomes excessively

high, an entrenchment effect may arise, leading to opportunistic behavior and increased risk-taking ([Morck et al., 1988](#); [Adu-Ameyaw et al., 2022](#)). Hence, ownership structure may determine whether diversification and profitability enhance or, conversely, weaken bank stability.

The urgency of this study lies in the need to understand how key internal factors in Islamic banking, namely diversification strategy, profitability efficiency, and ownership governance, interact to shape systemic stability under conditions of global uncertainty. Asian OIC countries account for over 60% of total global Islamic banking assets, yet continue to face challenges such as regulatory fragmentation, governance gaps, and limited diversification of productive assets. A cross-country integrative framework is therefore essential to provide empirical evidence on whether current Islamic banking models are genuinely resilient in the post-global-crisis era. Moreover, the findings are expected to guide financial authorities in strengthening governance performance linkages that balance profitability objectives with long-term stability.

This study makes several contributions to the literature on Islamic banking stability. First, it proposes a novel conceptual model that integrates asset diversification, profitability, and managerial ownership within a moderated mediation framework to explain Islamic bank stability in Asian OIC countries, an approach rarely adopted in prior Islamic banking studies ([Sahyouni & Wang, 2019](#)); [Alqahtani et al., 2022](#)). Second, from a methodological perspective, the study employs Hayes' PROCESS Model 15 to simultaneously test direct, mediating, and moderating effects, offering a more comprehensive analytical framework than conventional regression-based approaches commonly used in this field ([Hayes, 2018](#); [Hair et al., 2022](#)). Third, the empirical findings reveal a negative effect of managerial ownership on Islamic bank stability, indicating the emergence of agency-related governance issues. This result extends the Islamic banking governance literature, which has largely emphasized the disciplining role of ownership structures ([Farag et al., 2018](#); [Mollah et al., \(2019\)](#)). Finally, by adopting a post-crisis perspective, the study contributes to the literature on Islamic banking resilience by assessing diversification and governance mechanisms in a period characterized by heightened systemic uncertainty ([Hasan et al., 2021](#)). Overall, this study advances the agency governance perspective in Islamic banking and provides relevant policy implications for regulators and practitioners to enhance long-term financial stability.

This study is grounded in the Financial Intermediation Theory as its grand theory, which emphasizes the role of financial institutions particularly banks as intermediaries between surplus and deficit units, while managing liquidity and risk. At the middle-theory level, it draws upon Agency Theory, Portfolio Theory, and Financial Economics Theory.

- Agency theory explains potential conflicts of interest between bank owners and managers.
- Portfolio theory highlights the importance of asset diversification in minimizing risk and optimizing returns.
- Financial economics theory provides the analytical basis for measuring financial performance and stability.

At the applied theory level, this study integrates empirical constructs such as asset diversification, profitability, managerial ownership, and bank stability. The concept of bank efficiency has evolved substantially since its roots in classical economic and financial theory. A foundational principle is the Efficient Market Hypothesis (EMH) proposed by Eugene Fama in the 1960s, which asserts that asset prices fully reflect all available information,

making it impossible for investors to consistently outperform the market. This principle was later adapted to evaluate operational and financial efficiency in banks (Lo, 2018).

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By the 1980s, efficiency analysis shifted toward productivity and operational performance, especially through the Data Envelopment Analysis (DEA) frontier approach. DEA has been widely used to measure technical and allocative efficiency, assess how effectively banks utilize resources to maximize output, and evaluate cost and risk management performance.

Asset diversification refers to a portfolio allocation strategy aimed at reducing risk by spreading investments across various asset types or sectors. The concept originates from Portfolio Theory introduced by Markowitz (1952) in "Portfolio Selection", which posits that total portfolio risk can be minimized when asset returns are not perfectly correlated losses in one asset can be offset by gains in another.

One of the most widely debated determinants of bank stability is asset diversification. While modern portfolio theory Markowitz (1952) posits that diversification mitigates concentration risk and enhances resilience, the empirical verdict within the Islamic banking literature remains paradoxically fragmented. Recent studies present a dichotomy: some evidence suggests that diversification bolsters stability by creating internal capital markets (Hassan et al., 2023), whereas others contend that it exacerbates agency problems and operational complexity, thereby eroding stability Abedifar et al., (2018).

This persistent inconclusiveness highlights a critical theoretical and methodological lacuna. The existing "state of the art" has predominantly focused on the direct, linear relationship between diversification and stability, effectively treating the mechanism as a black box. This approach neglects the possibility that diversification is not a panacea, but a strategic lever that must first translate into profitability to impact stability. Furthermore, prior studies have largely overlooked the heterogeneous nature of ownership structure in OIC countries, failing to account for how different governance incentives can amplify or suppress the benefits of diversification.

To address these gaps, this study departs from conventional direct-effect models by proposing a moderated mediation framework that explicitly integrates asset diversification, profitability, and managerial ownership to explain Islamic bank stability. Using post-pandemic data (2020–2024) from Islamic banks across Asian OIC countries, this research investigates how diversification affects stability through profitability, and under what ownership conditions this mechanism holds. By positioning profitability as a transmission channel and managerial ownership as a boundary condition, the study advances the state of the art in Islamic banking research and provides policy-relevant insights into governance performance stability linkages in a period of heightened global uncertainty.

Building on portfolio theory, agency theory, and financial intermediation theory, this study conceptualizes bank stability as the outcome of strategic asset allocation, profitability performance, and internal governance mechanisms. Asset diversification is expected to influence bank stability not only directly, but also indirectly through its impact on profitability, as diversified asset portfolios may enhance earnings capacity and reduce income volatility. However, the effectiveness of this transmission mechanism is likely to depend on governance incentives, particularly managerial ownership, which can either align managerial decisions with long-term stability objectives or, when excessive, exacerbate risk-taking behavior.

Accordingly, this study aims to investigate the effect of asset diversification on Islamic bank stability in Asian OIC countries by explicitly incorporating profitability as a mediating

mechanism and managerial ownership as a moderating governance factor. This inquiry is particularly important given the regulatory heterogeneity and governance challenges faced by Islamic banks in emerging Asian markets. By clarifying how and under what ownership conditions diversification strategies translate into stability outcomes, the study provides timely empirical evidence to inform post-crisis policy design and governance reforms aimed at strengthening the long-term resilience of the Islamic banking sector. By adopting a moderated mediation perspective, this study provides new insights into how and under what governance conditions asset diversification translates into Islamic bank stability in Asian OIC countries (Ntim, C. G., 2009)

The proposed conceptual model is illustrated in Figure 2, depicting the hypothesized relationships among asset diversification, bank profitability, managerial ownership, and bank stability.

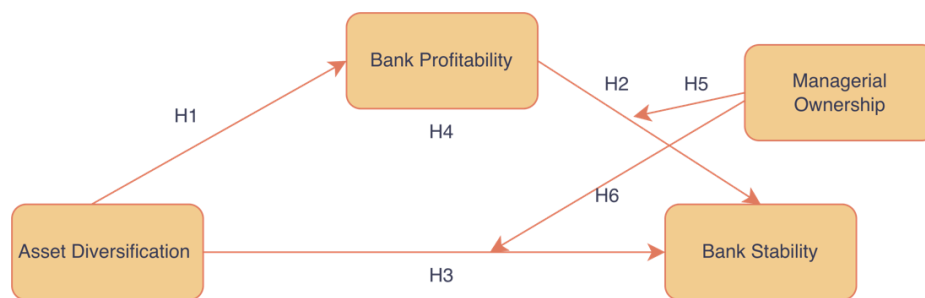


Figure 2.
Research
Framework

Asset diversification reflects a bank's strategic allocation of assets across financing portfolios, securities, and liquid instruments to optimize risk–return trade-offs and enhance resource utilization. While Modern Portfolio Theory [Markowitz \(1952\)](#), provides the theoretical foundation for diversification benefits, recent Islamic banking studies emphasize that diversification outcomes depend heavily on institutional context and contract heterogeneity. In Islamic banks, diversification involves balancing trade-based, lease-based, and profit-and-loss sharing contracts, each with distinct risk profiles and monitoring costs.

Recent empirical evidence suggests that asset diversification can enhance profitability by stabilizing income streams and reducing dependence on a single financing segment. Studies focusing on Islamic and dual banking systems find that diversified asset structures improve ROA when banks possess adequate risk management capacity and operational efficiency ([Paltrinieri et al., 2021](#); [Nguyen & Vo, 2022](#); [Viverita et al., 2023](#)). However, other recent findings indicate that excessive or poorly managed diversification may erode profitability by increasing complexity, coordination costs, and agency problems, particularly in emerging markets ([Kim et al., 2020](#); [Adem, 2023](#)). These mixed results suggest that while diversification is expected to support profitability, its effectiveness is not uniform across banks.

H₁: Asset Diversification has a positive effect on Profitability (ROA).

Profitability reflects a bank's capacity to generate sustainable earnings and accumulate internal capital buffers. Contemporary extensions of Franchise Value Theory argue that profitable banks are better positioned to absorb shocks, maintain depositor confidence, and engage in prudent risk-taking behavior to preserve long-term value. In the Islamic banking context, profitability is particularly important due to limited access to external liquidity instruments and the reliance on retained earnings for capital strengthening.

Recent empirical studies provide support for the stabilizing role of profitability. Evidence from Islamic and conventional banks shows that higher ROA is associated with stronger Z-

scores and lower insolvency risk, especially in post-crisis periods ([Sahyouni & Wang, 2019](#)). Nonetheless, newer studies caution that high profitability may also encourage risk-taking when governance mechanisms are weak or managerial incentives are misaligned ([Mollah et al., 2019](#); [Adu-Ameyaw et al., 2022](#)). This suggests that the profitability stability relationship, while generally positive, may be sensitive to governance conditions.

H₂: Profitability (ROA) has a positive effect on Bank Stability.

Beyond its effect on profitability, asset diversification may directly influence bank stability through risk-spreading mechanisms. By reducing concentration in specific sectors or financing types, diversification can mitigate exposure to idiosyncratic shocks and smooth earnings volatility. Recent studies highlight that this mechanism is particularly relevant for Islamic banks, whose asset-backed financing structures are vulnerable to sectoral downturns ([Paltrinieri et al., 2021](#); [Safiullah, 2021](#)).

However, recent empirical findings also indicate that diversification does not universally enhance stability. In environments characterized by limited high-quality Sharia-compliant investment opportunities, diversification may increase credit risk and monitoring costs, thereby weakening stability ([Kim et al., 2020](#); [Bitar et al., 2021](#)). Studies focusing on emerging Islamic banking markets show that diversification improves stability only when supported by strong governance and risk controls ([Hunjra et al., 2021](#); [Adem, 2023](#)) provide evidence of a positive association between asset diversification and stability, particularly when diversification is accompanied by strong risk governance [Hunjra et al., \(2021\)](#).

H₃: Asset Diversification has a positive direct effect on Bank Stability.

Asset diversification may also affect bank stability indirectly through profitability. Diversified asset portfolios can enhance income stability and asset utilization efficiency, which strengthens profitability and, in turn, improves capitalization and resilience. Recent literature conceptualizes profitability as a key transmission channel linking asset structure to financial stability within the intermediation and efficiency framework ([Berger & Bouwman, 2015](#); [Paltrinieri et al., 2021](#)).

Nonetheless, recent empirical evidence suggests that this mediation effect is conditional. If diversification fails to generate sufficient returns or leads to inefficiencies, profitability may not improve, thereby weakening the indirect stability channel ([Viverita et al., 2023](#); [Alshammari et al., 2024](#)). This provides a plausible explanation for the inconsistent mediation effects reported in prior studies.

H₄: Profitability mediates the effect of Asset Diversification on Bank Stability.

Managerial ownership represents a key internal governance mechanism shaping managerial incentives. Contemporary agency-based studies argue that moderate managerial ownership can align managerial and shareholder interests, promoting prudent risk-taking and long-term stability. In Islamic banking, where ethical conduct and sustainability are emphasized, managerial ownership may reinforce conservative financial behavior.

However, recent empirical research highlights a non-linear effect. Excessive managerial ownership may lead to entrenchment, weakened external monitoring, and higher risk-taking behavior, thereby undermining stability ([Adu-Ameyaw et al., 2022](#); [Pham et al., 2023](#)). Recent banking studies show that ownership structure conditions the extent to which profitability translates into stability outcomes ([Farak et al., 2018](#); [Mollah et al., 2019](#)).

H₅: Managerial Ownership moderates the relationship between Profitability and Bank Stability (second-stage moderation), such that the effect of ROA on stability is stronger at higher levels of managerial ownership.

Managerial ownership may also shape how asset diversification affects bank stability. Managers with ownership stakes are expected to exercise greater caution in diversification decisions, prioritizing asset quality and long-term risk considerations. Recent studies suggest that aligned ownership incentives enhance internal monitoring and improve the effectiveness of diversification strategies (Pham et al., 2023; Adem, 2023).

Conversely, when managerial ownership leads to excessive control and reduced accountability, diversification decisions may reflect managerial preferences rather than optimal risk management, potentially weakening stability. This conditional effect has been documented in recent governance studies focusing on emerging and Islamic banking markets (Bitar et al., 2021; Adu-Ameyaw et al., 2022).

H₆: Managerial Ownership moderates the direct effect of Asset Diversification on Bank Stability.

METHODS

To empirically examine the proposed relationships, this study operationalizes all variables using established measurements widely adopted in prior banking and Islamic finance literature. The selection of measurement indicators is guided by theoretical relevance, empirical validity, and data availability across Islamic banks in OIC Asia countries. Asset diversification, bank stability, profitability, and governance variables are measured following standard approaches to ensure comparability with previous studies and the robustness of the empirical results.

The detailed measurement and operational definitions of all variables are presented in Table Operational Definition of Variables below:

No	Variable	Symbol	Definition	Measurement / Formula	Source
1	Asset Diversification	ADI	Degree of asset diversification across financing, securities, liquid assets, and non-financial assets	$HI = \sum_{k=0}^n \binom{n}{k} x^k a^{n-k}$	Elsayed & Wahba (2023); Berger et al. (2010); Bitar et al. (2021); Trinh & Vu (2024)
2	Bank Stability	Z-score	Bank's distance from insolvency reflecting profitability, capitalization, and earnings volatility	$Z = \frac{ROA + \frac{Equity}{Assets}}{\sigma(ROA)}$	Bitar et al. (2021); Trinh & Vu (2024)
3	Bank Profitability	ROA	Ability of the bank to generate net income from total assets	$ROA = \frac{Net\ Income}{Total\ Assets}$	Mollah et al. (2019)

Table 1.
Operational
Variabel

4	Managerial Ownership	MO	Proportion of shares owned by directors or executive management	$MO = \frac{\text{Directors' Shares}}{\text{Total Outstanding Shares}} \times 100\%$	Morck et al. (1988); Bhagat & Bolton (2008)
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This study employs secondary data collected from annual reports, financial statements, corporate governance reports, and official publications by banking regulators or capital market authorities in Asian OIC member countries. To complement macroeconomic variables (e.g., real GDP and inflation used as controls), data were obtained from publications by the World Bank, IMF, and relevant central banks.

Asset diversification is measured using the Herfindahl Hirschman Index (HHI), which is widely applied in banking studies to assess asset concentration and diversification levels ([Elsayed & Wahba, 2023](#)). Although originally developed in industrial economics to measure market concentration, the HHI has been extensively adopted in banking research to evaluate the distribution of assets across different categories.

The HHI is computed as the sum of squared proportions of each asset category relative to total assets, as follows:

Based on available data, there are 43 Islamic banks identified across nine Asian OIC countries with full-fledged Islamic banking operations, while six countries (Guyana, Kyrgyzstan, Tajikistan, Azerbaijan, and Uzbekistan) do not have identifiable Islamic banks.

Samples were determined using purposive sampling, applying the following criteria:

1. Fully-fledged Islamic banks (not Islamic windows or units of conventional banks).
2. Operated for at least the entire research period (2010–2024).
3. Published complete annual reports consistently for 2020–2024.
4. Provided complete governance data (managerial ownership, institutional ownership, independent board members, and board meeting frequency).

No	Sample Selection Criteria	Number of Banks
1	Full-fledged Islamic banks in OIC member countries	36
2	Operating since at least 2010	30
3	Published complete annual reports (2020–2024)	25
4	Complete corporate governance data	7
	Total Sample	7
	Total Observations (7 banks × 5 years)	35

Table 2.
Summary of Sample Selection

Although the number of banks appears limited, this study employs a panel data structure with bank year observations as the unit of analysis. Following common methodological guidelines, a minimum of 30 observations is generally considered sufficient for regression-based mediation and moderation analysis ([Hayes, 2018](#); [Hair et al., 2022](#)). The final sample consists of 7 full-fledged Islamic banks observed over five years (2020–2024), yielding 35 bank-year observations, which exceeds the minimum threshold required for reliable statistical inference. Therefore, the sample size used in this study is considered adequate for the proposed empirical analysis.

Table 3.
List of
Sampled
Islamic
Banks (Asian
OIC Group)

No	Country	Bank Name	Ownership Status
1	Indonesia	Bank Muamalat Indonesia	Private
2	Malaysia	Bank Islam Malaysia Berhad	National
3	Maldives	Maldives Islamic Bank	National
4	Bangladesh	Shahjalal Islami Bank PLC	Private
5	Pakistan	Al Baraka Bank (Pakistan) Ltd.	Private (affiliate of Al Baraka Group, Bahrain)
6	Pakistan	Bank Islami Pakistan Ltd.	Private
7	Türkiye	Kuwait Turkish Participation Bank Inc.	Joint Venture (Kuwait Finance House + Turkish investors)

Data were analyzed using a regression-based moderated mediation approach. Specifically, Hayes' PROCESS macro Model 15 was employed to simultaneously examine the direct effect of asset diversification on Islamic bank stability, the mediating role of profitability, and the moderating role of managerial ownership. The analysis was conducted using ordinary least squares (OLS) estimation with bootstrapping procedures to assess the significance of indirect and conditional effects by (Hayes, 2018). These steps serve as robustness checks to validate the moderation effects estimated through the Hayes model. The core of this analysis is to examine whether corporate governance mechanisms specifically managerial ownership strengthen or weaken the influence of key banking variables, namely asset diversification and profitability, on Islamic bank stability. The study adopts Hayes' PROCESS Model 15, which integrates mediation (profitability as the mediator) and moderation (managerial ownership as the moderator) within a single analytical framework.

Although the application of PROCESS Model 15 is methodologically appropriate for capturing second-stage moderated mediation effects, the relatively small sample size comprising seven Islamic banks in OIC Asian countries raises potential concerns regarding external validity and inferential power. This limitation reflects a structural data availability constraint rather than a sampling bias, as only a limited number of Islamic banks in the region consistently disclose complete and comparable data on managerial ownership, asset diversification, and financial performance across the observation period.

To address this limitation, the study prioritizes internal validity and theory-driven inference over broad statistical generalization. The use of bootstrapping procedures within the PROCESS framework, which do not rely on normality assumptions, is particularly suitable for small-sample analysis and enhances the robustness of the estimated mediation and moderation effects (Hayes, 2018). Accordingly, the findings are interpreted as analytical insights within a specific institutional and regulatory context of Islamic banking in OIC Asia, providing a basis for future large sample validation.

$$M = a_0 + a_1X + e_1$$

$$Y = b_0 + cX + b_1M + b_2W + b_3(M \times W) + b_4(X \times W) + e_2$$

The conceptual model follows the configuration of Hayes' PROCESS Model 15, which integrates mediation and moderation effects. The variables in the model are defined as follows:

X = Asset Diversification

M = Profitability (ROA)

Y = Bank Stability (Z-score)

W = Managerial Ownership

c' = Direct Effect

$a_1 \times b_1$ = Indirect Effect

b_3, b_4 = Moderation effects on the $M \rightarrow Y$ and $X \rightarrow Y$ paths

RESULT AND DISCUSSION

RESULT

To ensure the appropriateness of the regression specification, a model feasibility test was conducted prior to the main analysis. The test evaluates whether the set of independent variables asset diversification, profitability, managerial ownership, and their interaction terms jointly provides a statistically adequate explanation of the variation in bank stability. The results of this assessment are summarized in Table 3.

R	R-Sq	F(HC4)	p
0,474	0,225	3,888	0,007

Table 4.
Model Feasibility Test

Source: Table generated by the author

As presented in Table 3, the model exhibits an R^2 of 0.225 and a highly significant F-statistic ($F = 3.888; p < 0.01$). While an R^2 of 22.5% might appear moderate, it is statistically robust within the context of cross-country stability modeling. Bank stability (Z-Score) is inherently multidimensional, heavily driven by exogenous macroeconomic shocks, regulatory landscapes, and systemic risks that lie outside the scope of firm-level variables. Consequently, capturing nearly a quarter of the variation in stability solely through internal strategic levers (diversification, profitability, and ownership) represents a substantial explanatory contribution. The significant F-test confirms that, despite the presence of external noise, the selected internal determinants serve as critical and valid predictors of bank resilience.

Building upon the confirmation that the model is statistically feasible and appropriate for further analysis, the next step involves examining the direct relationships between each independent variable and bank stability. The estimated coefficients and their significance levels are summarized in Table 4.

	Coefficient	p
Asset Diversification	4,734	0,302
Profitability	0,403	0,497
Managerial Ownership	-0,074	0,014

Table 5.
Direct Effects

Source: Table generated by the author

The estimation results reveal nuanced relationships between the predictors and bank stability. First, asset diversification exerts a positive but statistically insignificant influence on stability ($\beta = 4.734; p = 0.302$). Theoretically, this deviation from the traditional Portfolio Theory suggests the presence of a "complexity discount" in Islamic banking. While diversification aims to spread risk, the operational complexity of managing heterogeneous Sharia-compliant assets (e.g., varying risk profiles of *Murabaha* vs. *Musharakah*) may generate monitoring costs that neutralize the intended diversification benefits. Furthermore, the limited array of high-quality liquid Islamic instruments in OIC Asia countries often forces banks to hold correlated assets, thereby dampening the variance-reduction effect of diversification.

Similarly, profitability demonstrates a positive but insignificant effect on stability ($\beta = 0.403$; $p = 0.497$). This finding challenges the "buffer capital theory," which posits that higher earnings automatically build resilience. Instead, the result aligns with the "risk-shifting hypothesis," implying that higher profitability in this sample may be driven by aggressive risk-taking behaviors. If profits are derived from high-risk financing or are distributed as dividends rather than retained as capital buffers, the net impact on stability becomes negligible.

In contrast, managerial ownership reveals a significant negative impact on bank stability ($\beta = -0.074$; $p = 0.014$). This empirical evidence strongly supports the "Entrenchment Hypothesis" over the "Alignment of Interest" theory. High equity stakes appear to insulate managers from internal disciplinary mechanisms, incentivizing them to pursue high-risk, high-return strategies to maximize their personal wealth. This behavior aligns with Agency Theory predictions where entrenched managers, protected by their ownership power, may engage in opportunistic actions that erode long-term institutional resilience.

This section presents the results of the moderation analysis, examining how the interaction terms influence the relationship between the key variables in the model:

Table 6.
Moderation
Effects

	Coefficient	p
Interaction 2	-0,451	0,377
Interaction 2	-0,035	0,658

Source: Table generated by the author

Table 5 presents the results of the moderation analysis, examining whether managerial ownership acts as a boundary condition for the relationships between asset diversification, profitability, and bank stability. Contrary to the Agency Theory prediction that ownership aligns interests and enhances strategic effectiveness, the empirical results reveal a "governance decoupling" phenomenon.

First, the interaction between asset diversification and managerial ownership is statistically insignificant ($\beta = -0.451$; $p = 0.377$). This finding indicates that increasing managerial equity stakes does not amplify the stability benefits of diversification. Theoretically, this suggests the presence of "Regulatory Rigidities" in Islamic banking. Unlike conventional counterparts, Islamic bank managers operate under dual-governance structures (Board of Directors and Sharia Supervisory Board). This rigorous oversight likely limits the discretionary power of managers to aggressively restructure asset portfolios for stability, rendering their ownership stakes "symbolic" rather than "strategic" in influencing diversification outcomes.

Second, the interaction between profitability and managerial ownership is also insignificant ($\beta = -0.035$; $p = 0.658$). This implies that higher managerial ownership fails to transform profitability into greater stability. This result points to a "Dividend Preference Mechanism" or Managerial Myopia. Even when managers hold shares, they may prioritize immediate dividend payouts (to realize personal wealth from their shares) over retaining earnings to bolster the bank's capital buffers. Consequently, the potential transmission of profitability into long-term stability is severed, regardless of the managers' ownership concentration.

Overall, the insignificance of these interaction terms contributes a vital insight to the literature: in the OIC Asia Islamic banking context, managerial ownership is not a potent governance mechanism for modulating strategic outcomes. Instead, stability appears to be driven more by structural constraints and external regulations than by internal incentive alignments.

To validate these findings, a higher-order moderation significance test was conducted, and its results are summarized in Table 6.

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	R ² change	F (HC4)	p
X*W	0,013	0,803	0,377
M*W	0,002	0,199	0,685

Table 7.
Moderation
Significance
Test

Source: Table generated by the author

To rigorously validate the interaction effects, a higher-order moderation test was conducted. As summarized in Table 6, the addition of interaction terms yields negligible improvements in the model's explanatory power. Specifically, the interaction between asset diversification and managerial ownership (X x W) results in a minimal R² change of 0.013 (F = 0.803; p = 0.377), while the interaction between profitability and managerial ownership (M x W) contributes an even smaller increment of 0.002 (F = 0.199; p = 0.658).

Statistically, these results confirm that managerial ownership does not operate as a significant moderator. However, theoretically, this "non-finding" offers critical insight into the "Governance-Performance Decoupling" within the examined OIC banking sectors. The insignificance suggests that managerial equity stakes in these markets are likely "symbolic" rather than "strategic."

Two theoretical mechanisms explain this phenomenon:

1. **Constrained Managerial Discretion:** Unlike conventional banking, Islamic bank managers operate under a "dual-governance" structure involving Sharia Supervisory Boards (SSB). This additional layer of oversight may rigidify decision-making, limiting the ability of managers even those with high ownership to dynamically adjust diversification strategies for stability purposes. Consequently, ownership incentives are neutralized by regulatory strictness.
2. **The "Ineffective Incentive" Hypothesis:** The insignificant interaction with profitability implies that managerial ownership fails to align interests toward long-term capital retention. Instead of using profits to build stability buffers (retained earnings), managers may be pressured by short-term market volatility or dividend demands. This aligns with the observations of [Mollah et al., \(2019\)](#), [Abubakar & Sulaiman \(2021\)](#) who argue that in developing financial systems with weak external legal protection, internal governance mechanisms like managerial ownership often become dormant or ineffective in mitigating risk.

Therefore, the empirical evidence points to a structural limitation: simply increasing managerial ownership is insufficient to amplify the benefits of diversification or profitability on stability in the Asian OIC context.

Indirect Path	Estimate (ab)	Boot SE	BootLLCI	BootULCI	Decision
X → M → Y	0.048	0.071	-0.091	0.209	Not significant (CI includes 0)

Table 8.
Indirect Path
and
Mediation
Analysis

Source: Table generated by the author

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To examine the underlying mechanism connecting asset strategies to resilience, a mediation analysis was conducted using the PROCESS macro with 5,000 bootstrap samples. The objective was to test whether Profitability (ROA) serves as a conduit (mediator) through which Asset Diversification influences Bank Stability. The statistical results, however, do not support the mediation hypothesis. As detailed in the output, the indirect effect of asset

diversification on stability through profitability is statistically insignificant, evidenced by the bias-corrected 95% confidence interval containing zero. The path from Profitability to Stability (MxY) is insignificant ($\beta = 0.403$; $p = 0.497$), as is the direct effect of diversification on stability (XxY) ($\beta = 4.734$; $p = 0.302$).

Theoretically, this "failed mediation" signals a "Transmission Mechanism Breakdown" in the studied Islamic banking sector. Two critical economic rationales explain this disruption:

1. The "Hollow Profitability" Phenomenon: The insignificance of the profitability-stability path suggests that higher earnings are not being effectively converted into capital buffers. In the context of Asian OIC banks, this points to a "Dividend-Bias" behavior, where generated profits are prioritized for shareholder payouts or high-cost operational expansions rather than being retained to strengthen the equity base (Retained Earnings). Consequently, even if diversification generates profit, that profit "leaks out" of the system before it can reinforce the bank's Z-Score (solvency)
2. Operational Inefficiency Costs: The inability of diversification to trigger a stability pathway through profit indicates that the costs of complexity outweigh the benefits of scope. Managing a diversified portfolio of Sharia-compliant assets requires specialized monitoring and distinct governance compliance, which escalates operating costs. These "complexity costs" erode the profit margins that would otherwise contribute to stability, rendering the mediation path ineffective.

In summary, the empirical evidence confirms that for Islamic banks in this region, profitability does not act as a functional bridge for stability. Resilience appears to be driven by other structural factors such as capital injection or regulatory compliance rather than through the organic channel of diversified earnings.

DISCUSSION

Asset diversification has a positive but insignificant impact on profitability.

The empirical results show that asset diversification has a positive but statistically insignificant effect on profitability, leading to the rejection of H1. From the perspective of portfolio theory, diversification is expected to enhance performance by reducing idiosyncratic risk and stabilizing returns. However, this theoretical benefit assumes the availability of sufficiently heterogeneous assets and low marginal monitoring costs.

In Islamic banking, particularly within Asian OIC countries, these assumptions are only partially met. Although diversification expands financing and investment portfolios, it simultaneously increases operational complexity due to heterogeneous Sharia-compliant contracts, higher monitoring requirements, and limited standardization. As a result, the additional costs associated with managing diversified Islamic assets tend to offset the potential revenue gains, leading to an insignificant net effect on ROA.

This finding contradicts [Abedifar et al. \(2018\)](#) and [Elsiefy \(2021\)](#), who document efficiency gains from diversification, but supports the "complexity cost" argument advanced by [Huu Vu & Thanh Ngo \(2023\)](#). Importantly, the insignificance observed in this study is also driven by data characteristics: the sampled banks operate in relatively shallow Islamic financial markets with limited diversification instruments, constraining the profitability-enhancing role of asset expansion.

Profitability has a positive but insignificant impact on bank stability.

The results indicate that profitability has a positive but insignificant impact on bank stability, as measured by the Z-score, leading to the rejection of H2. According to buffer capital theory, higher profitability should strengthen capital buffers and improve resilience against shocks. However, this mechanism presumes that profits are retained and converted into capital.

The insignificant relationship found in this study suggests that higher ROA does not necessarily translate into greater stability in Islamic banks. One plausible explanation lies in the risk-shifting hypothesis, where profitability may be driven by aggressive financing strategies rather than prudent risk management. In such cases, short-term profits do not enhance long-term stability.

This finding contrasts with [Sahyouni & Wang \(2019\)](#), who report a stabilizing role of profitability, but aligns with studies emphasizing that profit quality matters more than profit magnitude. From the data perspective, the sampled banks exhibit relatively volatile earnings and dividend-oriented profit distribution patterns, weakening the link between profitability and capital-based stability indicators.

Asset diversification has a positive but insignificant impact on bank stability.

The analysis reveals that asset diversification has a positive but statistically insignificant effect on bank stability, resulting in the rejection of H3. Risk-spreading theory posits that diversification reduces asset volatility and enhances stability. However, this effect is conditional on asset heterogeneity and low correlation among asset classes.

In the context of Islamic banks in Asian OIC countries, diversification opportunities are structurally constrained. The limited availability of high-quality and liquid Islamic instruments forces banks to hold assets with similar risk characteristics. Consequently, diversification fails to generate meaningful variance reduction, diminishing its stabilizing impact.

This finding does not support [Meslier et al. \(2014\)](#) and [Tabash et al. \(2019\)](#), but is consistent with [Berger et al. \(2010\)](#) and [Kim et al. \(2020\)](#), who highlight the “complexity discount” effect. From the data standpoint, the concentration of financing in a few dominant sectors further explains why diversification does not significantly enhance stability in this sample.

Managerial ownership has a negative and significant impact on bank stability.

The results show a negative and statistically significant effect of managerial ownership on bank stability, leading to the rejection of the interest-alignment hypothesis. Agency theory suggests that managerial ownership aligns managers’ interests with those of shareholders, thereby reducing risk. However, beyond a certain threshold, higher ownership may entrench managers and weaken external monitoring.

This study provides strong evidence supporting the entrenchment hypothesis. Managers with substantial ownership stakes may gain excessive control and pursue riskier strategies to maximize private benefits, ultimately undermining bank stability. This effect is particularly pronounced in Islamic banks operating in governance environments with limited regulatory enforcement.

Consistent with [Mollah et al. \(2019\)](#) the findings suggest that managerial ownership in Islamic banks does not function as an effective governance mechanism. From the data perspective, the observed ownership concentration among insiders amplifies agency problems rather than mitigating them.

Profitability does not mediate the impact of asset diversification on bank stability.

The mediation analysis shows that profitability does not mediate the relationship between asset diversification and bank stability, leading to the rejection of H5. Although asset diversification may generate income, the insignificant indirect effect indicates that profitability does not operate as an effective transmission channel through which diversification enhances Islamic bank stability.

From a theoretical standpoint, the intermediation and buffer-capital view suggest that diversification strengthens stability only when it improves sustainable profitability that is subsequently retained as capital ([Berger & Bouwman, 2015](#)). In Islamic banking, this mechanism is constrained by the dominance of short-term, trade-based financing and the limited availability of long-term, high-yield Sharia-compliant instruments. As a result, diversification-related income tends to be volatile and insufficient to reinforce capital buffers, weakening the profitability stability linkage.

This explanation is consistent with recent empirical evidence. [Farooq et al. \(2022\)](#) and [Huu Vu and Thanh Ngo \(2023\)](#) show that in emerging Islamic banking markets, diversification often increases operational and monitoring costs without improving earnings quality, thereby limiting its stabilizing role. Evidence from Asian banks further indicates that diversification may smooth income flows but fails to translate into capital accumulation ([Paltrinieri et al., 2021](#); [Ben Jedidia & Hamza, 2021](#)). This pattern is also reflected in the present data, which exhibit low ROA variability and modest capital reinforcement over 2020–2024, confirming that profitability does not mediate the diversification stability relationship.

Managerial ownership does not moderate the impact of asset diversification or profitability on bank stability.

The interaction analysis shows that managerial ownership does not moderate the effects of asset diversification or profitability on bank stability, resulting in the rejection of H6. This indicates that variations in managerial ownership do not alter the strength or direction of the main relationships.

This result suggests that managerial ownership lacks the disciplinary capacity required to function as an effective governance mechanism. Weak legal protection, limited investor oversight, and concentrated ownership structures reduce the effectiveness of ownership-based controls.

Consistent with [Abubakar and Sulaiman \(2021\)](#), the findings highlight that in developing Islamic financial systems, managerial ownership often fails to mitigate agency problems. The insignificance is further reinforced by the small number of banks with meaningful variation in ownership structure within the dataset.

CONCLUSION

This study provides a critical re-examination of the governance stability nexus in Islamic banks operating within Asian OIC countries. Overall, the findings challenge the conventional predictions of Agency Theory and Portfolio Theory when applied to Islamic banking. Asset diversification and profitability do not function as automatic stabilizing mechanisms, indicating that the theoretical benefits of risk spreading and earnings buffers are weakened by the operational complexity and monitoring costs inherent in managing heterogeneous Sharia-compliant portfolios. In contrast, managerial ownership exhibits a destabilizing governance effect, lending support to the entrenchment perspective whereby higher managerial equity stakes may incentivize risk-shifting behavior rather than prudent oversight.

The absence of both mediating and moderating effects further suggests a decoupling between governance structures, performance outcomes, and financial stability in the dual-governance environment of Islamic banking.

From a practical perspective, these findings carry important implications for regulators and bank management. Policymakers should reconsider the assumption that higher managerial ownership necessarily aligns incentives and enhances stability, as such mechanisms may instead weaken risk discipline in environments with limited external monitoring. For bank managers, the results caution against the uncritical pursuit of asset diversification strategies without parallel investments in cost-efficient monitoring and risk management systems. Moreover, the weak linkage between profitability and stability underscores the importance of capital reinforcement policies that prioritize retained earnings over short-term distribution, ensuring that profits contribute meaningfully to long-term resilience.

Despite its contributions, this study is subject to several limitations that open avenues for future research. First, the analysis relies on accounting-based measures of stability and profitability, which may not fully capture market perceptions of risk or the specific vulnerabilities associated with Sharia non-compliance. Future studies could incorporate market-based stability indicators and explicit measures of Sharia governance to assess whether religious oversight mechanisms provide stronger stabilizing effects than conventional ownership structures. Second, the study does not explicitly model cross-country institutional differences, such as legal enforcement quality or regulatory regimes, which may shape the effectiveness of governance mechanisms in Islamic banks. Adopting an institutional economics perspective would allow future research to examine how national legal frameworks interact with bank-level governance and risk-taking behavior. Finally, the static nature of the empirical framework may not fully address potential endogeneity arising from the dynamic adjustment of bank stability. Future research is therefore encouraged to employ dynamic panel techniques to capture persistence effects and strengthen causal inference.

Taken together, this study contributes to the Islamic banking literature by demonstrating that stability outcomes are driven less by diversification strategies and internal ownership incentives, and more by the broader governance and institutional context in which Islamic banks operate. This insight advances the theoretical debate on financial stability and provides a more nuanced foundation for regulatory reform and future empirical inquiry.

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