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Financial Stability of Islamic Banks: The Case of the MENA Region

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Abstract: Financial stability in Islamic banks is often evaluated through credit risk and profitability indicators. This study focuses on the MENA region, employing panel data comprising 183 observations. Two empirical models are estimated to examine the effects of bank-specific and macroeconomic variables on non-performing loans (NPLs) and return on assets (ROA), respectively. Findings reveal a dual effect of the capital adequacy ratio: it increases credit risk while reducing profitability, possibly reflecting moral hazard behavior in highly capitalized banks. ROA is negatively affected by poor asset quality, suggesting that greater loan exposure may undermine financial performance. Loan loss provisions are positively linked to NPLs, underscoring the need for adequate buffers to absorb risk. Interestingly, the profitability ratio (net interest income to total assets) is strongly and positively associated with both NPLs and ROA, indicating that Islamic banks can sustain profitability despite rising credit risk. Moreover, GDP growth exerts a significant positive impact on profitability, while the crisis variable shows a counterintuitive yet significant positive effect on ROA and a negative effect on NPLs-highlighting the relative resilience of Islamic banks during financial crises. These findings shed light on the intricate relationship between risk, performance, and macroeconomic factors, offering valuable insights for bank managers, regulators, and policymakers aiming to enhance financial stability and operational efficiency in Islamic banking.

Keywords: Financial Stability, Islamic Banking, NLP, ROA, Credit Risk