

## Research on the Capital Adequacy Ratio, Good Governance and Leverage in Islamic Banking

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### Abstract

**Purpose:** This research mainly proposes to investigate the Islamic Banks considering Capital Adequacy Ratio (CAR) and corporate governance for 13 Muslim countries and the United Kingdom.

**Method:** Econometric panel data analysis is utilized for this research after necessary tests are used. The research data is taken from the World Bank and Islamic Financial Services Board web page.

**Results:** According to research results, a %1 augmentation in political stability causes a 0.0518 increase in Capital Adequacy Ratio (CAR), a %1 rise in regulator quality causes a 0.0416 increase in Capital Adequacy Ratio (CAR), a %1 increase in Capital to Asset Ratio causes to 0.708 increase in CAR (index). According to the research model, ROE, Control of Corruption, Government Effectiveness, and Political stability do not in a significant statistical relationship with Capital Adequacy Ratio.

**Implication:** The findings of this study suggest that there can be interpretation differences between conventional banks and their Islamic counterparts regarding banking financial management. In the regulative dimension, the existence and efforts of Basel regulations and the Islamic Financial Services Board develop in parallel with this context on the subject of CAR and other important dimensions of Islamic Banks.

**Originality:** This paper contributes to Islamic finance literature by integrating governance and leverage variables into a unified model for assessing CAR

**Keywords:** Capital Adequacy Ratio, Islamic Banks, Good Governance, Leverage.

**Article History:** Received: 24 January 2025      Revised: 25 February 2025      Accepted : 19 March 2025

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### How to cite (APAStyle):

Aiman, A., Risfandy, T., Aysan, A. F., & Saktiawan, B. (2025). Islamic financing and firm performance: evidence from Indonesia. *Journal of Finance and Islamic Banking*, 7(1), 1-20. <https://doi.org/10.21580/jiafr.2025.7.1.25148>

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## Introduction

Islamic financial and banking industry should be examined rigorously regarding two approaches. First of two, Islamic banking should focus on the developments in conventional financial markets because they sustain life on the border of this financial context, secondly Islamic trade and banking law because of the mutual and nutritional relationships. This paper mainly concentrates on the first relationship nexus by aiming to investigate the relationship between corporate governance variables and the capital adequacy ratio of Basel regulations. Corporate governance is one of the priorities of world financial and banking markets. Five items of the World Bank measure the efficiency, effectiveness and quality of banking systems regarding corporate governance around the world by countries. The countries, which utilize Islamic Banking, also are subjected to these measurements.

The total worth of global Islamic banking assets is estimated at US\$2104.1 billion following the development of the first modern Islamic commercial bank in 1975 (Ali et al, 2023: 629). Islamic banking offers financial products that adhere to religious prohibitions. Islamic banking stands on the principle of interest-free, avoids uncertainty in the transaction, prohibits speculation and invests in halal or Islamic-allowed services and goods. The word Islamic behind the term refers to real economic activity, social justice, well-being, consideration of morality in business and inculcation of broader interests of stakeholders (Zafar and Sulaiman, 2019: 357). On the other side, Abasimel (2023: 1923) underlines the main characteristics features of Islamic Banking as divinely sourced, shari'ah compliant banking system, rich with numerous financial concepts, riba (usury) free banking system, garar (uncertainty) free banking system, prohibits injustice, and enjoys benevolence in transactions.

The activities of Islamic Banking are widespread in the region of the Middle East, nevertheless, many developed countries from other regions have begun to value the massive demand for Islamic products (Ikra et al, 2020: 1044). Unlike its conventional counterpart, Islamic banking has some unique characteristics, including its sharing of profit and loss with its customers, offering of interest-free transactions and disapproval of trade transactions involving unethical and unlawful businesses, such as gambling, pornography, alcohol, etc (Banna et al, 2020: 312).

In some considerations, the Islamic banking system needs modifications to sustain its existence as compared with the conventional financial system. Therefore, the changes in Fiqh muamalat (Islamic commercial law) are raised as a solution (Ishak and Asni, 2020: 2138). On the other side, Moosa and Kashiramka (2022: 2200) and Tegambwage and Kasoga (2023: 3150) underline the importance of Shariah compliance (Islamic Law) as a determinative factor in consumer satisfaction and consumer loyalty. Moreover, profit and loss sharing is the main element for the establishment of banking whilst Shariah-compliant tools including partnership, leasing and sale-based arrangements are used for other banking offerings (Samsudeen et al, 2020: 411). There are gift zones in Islamic Banking and they are extremely important for a healthy banking system, Ahmad (1994) classifies these zones as theoretical matters which belong to sustain a business in a relatively narrower space of Islam, operational matters which are concerned with business making and technique development and strengthening of Islamic Banking Movement in competition with conventional banking

especially in Muslim World. Iqbal and Mirakhor (1999:382) divide the development of Islamic Banking into three parts that are development of a conceptual framework, experimentation and recognition and their main emphasis is the articulation of Riba (usury) to financial transactions of the modern world.

On the other side, the importance of the Capital Adequacy Ratio (CAR) can be very determinative because the consequences of a bank failure are usually very expensive; financial losses for the fund suppliers (shareholders, depositors, and insurers), loss of competitiveness of the banking industry and a destabilization of the financial system as a whole if several individual failures escalate into a banking crisis through contagion mechanisms (Louati et al, 2015: 192). CAR gain deep meanings in the banking risk-taking considerations, it is beneficial against credit risks in particular (Karim, 1996: 32). Concerning the determinants of bank stability, the findings suggest that the regulatory capital represents the primordial factor that reinforces the soundness of banking systems (Korbi and Bougatef, 2017: 312).

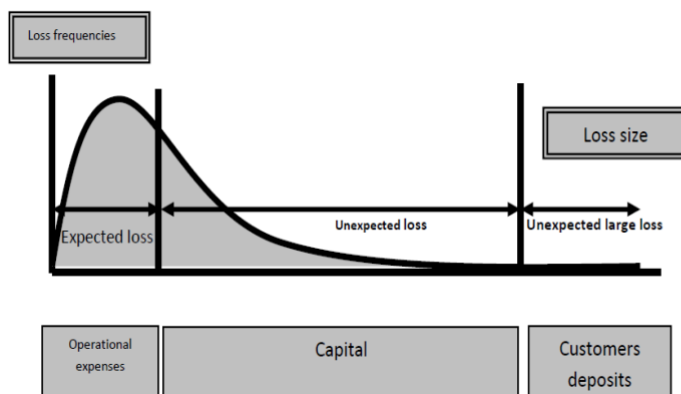
As it is looked at from this angle, it can be seen that Islamic finance is not a problem or an activity of ordinary entrepreneurship, it has a lot of deep roots and state and citizen-dependent acceptance requires a lot of attention. Therefore, Islamic banking institutions should focus on developing more deeper understanding of contemporary financial context and applications and corporate governance is one of them. World Bank examines governance degrees of the states under five titles political stability, government effectiveness, regulatory quality, rule of law and control corruption. These five dynamics are also subjected to this paper regarding their impacts on CAR. Therefore, the research serves to fill a gap in Islamic finance and corporate governance, leverage and earnings. The most important restriction of research is the dataset via available resources.

### **Literature Review**

Throughout history, the banking industry has suffered from some crises greatly. In many cases, it is observed a lack of conscious risk management. To solve risk problems and how to organize risk management designs and applications are scrutinized by a series of BASEL organizations and agreements. BASEL regulations try to govern the financial health of the banking industry regarding three pillars which are minimal capital requirements, the supervisory review process and market discipline (Muljawan et al, 2004: 429). For this cause, Basel regulations are not accepted as a final indicator of banking performance, but they should be confirmed as a comprehensive banking behaviour organizer with rules and regulations (Hall et al, 2000).

Nevertheless, there are two important observations of Obaidullah (1997) regarding Islamic Banking and CAR, one of them is the risk structure, assets and liabilities of Islamic banks are quite different affecting Basel Regulations' impacts and asset risks can transfer to investors, therefore the CAR on the conventional banks should be different. In this context, Islamic Banking is a relatively important part of the global financial industry and is an indispensable reality and mutual partner of the conventional banking system with all roots. Therefore, It is also a part of BASEL regulations' contracts. The following illustration shows the losses and how the banking industry can reciprocate these losses.

Figure 1. Losses in the Banking Industry



Resources: Tamimi and Fakhri, 2013: 45; Hassan, 2005: 9.

For Ismail and Sulaiman (2007), Capital arrangements which are designed by authorities, bring new hardships and challenges to the banking industry regarding recovery risk. The current Basel regulations' requirements and Islamic Financial Services Board standards are disincentives to Islamic banks to provide risk-sharing or partnership-based investments and services to their customers and depositors (Dolgun and Mirakhor, 2019: 56). The differences between conventional and Islamic finance are developed because of accounting standards in terms of Accounting and auditing organization for Islamic financial institutions (AAOFI) and International Financial Reporting Standards (IFRS) (Morshed, 2023).

More specifically, Basel regulations' requirements and the Islamic Financial Services Board (IFSB) arrange the capital structure of the Islamic Banking system through some special instruments and capital adequacy is one of them which limits excessive risks in the chain of the banking industry, on the other side, IFSB also intervenes to operating sides of Islamic Banking. Nevertheless, according to Khan and Jabeen (2010), they have complementary impacts on each other in terms of Islamic Banking. Noibi (2004: 56) pays attention to this situation by stating the hardships of the applicability of authorities' generic principles to Islamic Banking, for this cause, these principles cannot be utilized sometimes.

Nevertheless, Saba (2018) states that CAR is a necessary measure with its classifying capital structure, especially for emerging economies such as Pakistan. The analysis of Harkati et al. (2020: 1990) emphasises two important groups of banks regarding risk-taking one of them capital-dependent risky activities on the other side, the other group generally moves with risky assets. For Olalekan and Adeyinka (2013: 8), one of the important measures of banking profitability is CAR. Moreover, Capital adequacy is one of the bank's performance indicators with asset quality, management, earning & liquidity and sensitivity in CAMELS analysis (Mursal et al, 2019: 1). Besides these, Anjom and Faruq (2023: 320) maintain that capital adequacy with earning and banking sector development has a positive, conversely nonperforming investment has a negative and statistically significant effect on the financial stability of Islamic banks.

On the other side, Abusharba et al. (2013) explain the Capital Adequacy Ratio (CAR) with profitability (ROA), assets earning quality (NPF), deposit structure (DEP), liquidity

(FDR) and operational efficiency (OEIO) for Indonesia. On the other side, For Bateni et al. (2014), CAR is explained by Loan Asset Ratio (LAR), Return on Equity (ROE), Return on Asset (ROA) and Equity Ratio (EQR) in the Iran sample. Alnajjar and Othman (2021) accept ROA and ROE ratios as performance indicators which are greatly affected by CAR. Besides these, Akbar (2018) determines CAR is a measure of banking performance with Non-Performing Financing, Financing to Deposit Ratio and Good Corporate Governance in Indonesia which is one of the leading centres of Islamic Banking. For El Ansary and El Masry (2019: 287), the important variables are bank size, operational efficiency and GDP in the detection of Capital Adequacy Ratio for MENA countries.

For the analysis of Polat and Al Khalaf (2014), it can be said that loans to loan-to-asset ratio has negative impacts on the other side leverage and the size of the banks have positive impacts on the CAR in the Turkey sample. The comparison of El Ansary and Hafez (2015: 806) between the before-2008 and after-2009 periods sheds more light on the CAR mechanisms in the banking industry. According to this, Before the period 2008 results show that asset quality, size and profitability were the most significant variables. After the period 2009 results show that asset quality, size, liquidity, management quality and credit risk are the most significant variables that explain the variance of Egyptian banks' CAR.

**Methods**

The dataset of research was conducted for 13 Islamic countries (ANNEX 1) and the United Kingdom from 2018 to 2022. The dependent variable is the Capital Adequacy Ratio in the dataset, the independent variables can be counted as Return on Equity, Capital to Assets ratio, and governance variables such as control of corruption, government effectiveness, political stability, regulator quality and rule of law. Today, Islamic Finance scientists and thinkers are trying to develop an Islamic corporate governance understanding (Ulfi and Rizaldy, 2024). The main principles and mechanisms of this approach need extra effort. Nevertheless, It should be added that the mechanisms of Islamic Corporate Governance (ICG) make an extra contribution to sustainability of the Islamic banking in Islamic and non-Islamic countries (Kashi et al, 2024). On the other side, this research is limited because of some datasets about board dependence, transparency, social justice, corporate responsibility and corporal sustainability which can be good indicators of corporate governance or conceiving ICG. The independent variables can be defined in Table1.

Table 1. Good Governance Measures and Leverage ratios

Control of Corruption- (CONT of CORR)	Corruption undermines good governance and the rule of law, it negatively impacts service quality and efficiency and poses threats to principles of democracy, justice and the economy (Garycar and Sidebottom, 2012: 384). Bani-Mustafa et al. (2024) match control of corruption with special and unintended behaviours such as tax evasion, on the other side Basu et al. (1992) realize a similar analysis for bribery and control of corruption. On the other side, poverty, inequality, economic underdevelopment, cultural and demographic factors, different forms of governance
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Government Effectiveness (GovEFF)	<p>structures, historical determinism, a lack of competition and ethical frameworks can cause and result in the control of corruption (Meyer et al, 2024: 145). For Pippidi and Dadasov (2016: 415) perceptions of experts, and lack of both specificity and transparency should be a research purpose for governance structures.</p> <p>According to Kartiko et al (2024: 81), robust institutions are a pivotal factor in a country's economic growth and corruption control with government effectiveness are determinative roles in defining political stability. On the other side, Sanchez and Ballesteros (2013: 568) underline the importance of organizational environment, economic development and educational status are important elements in government effectiveness. Alam et al. (2017) and Magalhaes (2014) argue that government effectiveness can support a social structure and democracy in which good governance and fair financial management practices can flourish like public administration, public management and public policy. Especially increasing impacts of e-government projects and digitalism, the effectiveness of the government will be so important auditing mechanism (Sigwejo and Pather, 2016)</p>
Political stability (PolStb)	<p>For Caselli and Tesei (2011), political stability means political consistency, therefore there are no differences between Norway-type democracy and of autocracies of Saudi Arabia. Carmignani (2003) explains that political stability (political certainty) impacts economic growth, budget formation, inflation and monetary policy. Especially, political stability (Farooq et al., 2023; Asif et al., 2024; Kirikkaleli and Osmanlı, 2023) bears great burdens in policy uncertainty and environmental degradation. With financial development, human development and GDP, it is one of the essential economic indicators (Cui et al, 2023).</p>
Leverage Ratio (Capital to Assets-CtoA)	<p style="text-align: center;">Leverage Ratios</p> <p>Bank capital to assets is the ratio of bank capital and reserves to total assets. Capital and reserves include funds contributed by owners, retained earnings, general and special reserves, provisions, and valuation adjustments. Capital includes tier 1 capital (paid-up shares and common stock), which is a common feature in all countries' banking systems, and total regulatory capital, which includes several specified types of subordinated debt instruments that need not be repaid if the funds are required to maintain minimum capital levels (these comprise tier 2 and tier 3 capital). Total assets include all nonfinancial and financial assets.</p>
ROE (Return on Equity)	<p>Return on Equity (ROE) shows the income per equity.</p>

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The research mainly hypothesizes the following arguments in light of Table 1 and the relationship between Islamic Banking and Corporate Governance.

*Hypothesis 1:* The control of corruption has a positive impact on CAR in Islamic Banks.

*Hypothesis 2:* The government's effectiveness has a positive impact on CAR in Islamic Banks.

*Hypothesis 3:* Political stability has a positive impact on CAR in Islamic Banks.

*Hypothesis 4:* Regulatory quality has a positive impact on CAR in Islamic Banks.

*Hypothesis 5:* Return on Equity has a positive impact on CAR in Islamic Banks.

*Hypothesis 6:* The leverage Ratio has a positive impact on CAR in Islamic Banks.

A research model designed in the following form,

$$CAR_{ij} = a_{ij} + \text{Control of corruption}_{ij} + \text{Government effectiveness}_{ij} + \text{Political stability}_{ij} + \text{Regulatory\_Quality}_{ij} + ROE_{ij} + CtoA_{ij} + \varepsilon_{ij}$$

Equation 1.

The descriptive statistics on the dataset are given in Table 2, multicollinearity test results are given in Table 3, correlation results are given in Table 4 and autocorrelation results are given in Table 5.

Table 2. Dataset of the research

Statistics	CAR	ROE	CtoA	CONT of CORR	GovEFF	PolStb	Reg_qua
Mean	.1822669	.1215027	.0960168	-.0220573	.1556079	-.52716	.1253262
Standard Deviation	.0245765	.1848716	.0291322	.8525426	.8941643	1.102008	.7971694
Variance	.000604	.0341775	.0008487	.7268289	.7995297	1.214421	.635479
Skewness	.4681845	-.435292	-.181892	.3907223	-.29248	-.348559	-.096168
Kurtosis	4.8973	5.408652	1.982507	2.429993	2.33707	2.12691	2.21105
Min	.114731	-.483869	.0353137	-1.502881	-1.8795	-2.75326	-1.38916
Max	.262816	.6320614	.1531533	1.806572	1.4499	1.25736	1.76942
N	70	70	70	70	70	70	70

Table 3. Multicollinearity test results

Variable	VIF	1/VIF
GovEFF	16.70	0.059872
Reg_qua	15.41	0.064895
CONT of CORR	10.87	0.092033
PolStb	6.21	0.161140
CtoA	1.75	0.572831
ROE	1.40	0.714264
Mean VIF	8.72	

Table 4. Correlation results

	CAR	ROE	CtoA	CONT of CORR	GovEFF	PolStb	Reg_qua
CAR	1						
ROE	0.230	1					
CtoA	0.378	-0.104	1				
CONT of CORR	0.065	-0.070	0.514	1			
GovEFF	0.196	0.076	0.4289	0.9253	1		
PolStb	0.132	0.011	0.589	0.864	0.884	1	
Req_qua	0.140	-0.099	0.465	0.940	0.943	0.863	1

### Results and Discussion

Whether there are individual effects or time effects on the data, F-tests are utilized on the data set. With the detection of the existence of these two important effects, the two-way fixed effect regression model is selected. But, in light of the argument that the data include time restrictions depending on the data set (only 5 years), there are data limitations on the research model. For these causes, the time effect was disregarded. To reach strong individual effects explanations fixed effect (FE), estimation (F test), random effect (RE) estimation (Breusch Pagan LM test) and maximum likelihood (MLE) estimation (LR test and Score test) have been utilized on the Stata program and results taken. To make a selection between RE and FE, it is utilized the Hausman test.

The results are given in Table 2 and according to model selection results Fixed Effect (FE) estimation results are selected to continue the analysis (Tatoğlu, 2020). Fixed effect models show that the coefficients can change due to units. Shortly, fixed effect models describe the units with different features and these features can be represented that the unit value can change in the model with low N and high T values. The model can concentrate on the changes in units for dummy variables, for this cause, the model with dummy variable approach is another name of the model. (Coşkun and Güngör, 2015; Baltagi, 2021; Hsiao, 2022). The fixed estimation results are given in Table 3.

Table 3. Model Statistics

	Statistics		
R <sup>2</sup>	0.5		
F test	5.783		
Score test			70.545
Breusch Pagan LM test		12.448	
Ki-kare test			10.172
Hausman		14.142	
P	0.000	0.000	0.000

Table 4. The coefficient estimation results

<i>Variable (Capital Adequacy Ratio)</i>	<i>FE</i>	<i>RE</i>	<i>MLE</i>
ROE	-0.037	0.023	0.023*
Capital to Asset Ratio	0.691***	0.612***	0.608***
Control of Corr	-0.296	-0.0312	-0.0319***
GovEFF	-0.0108	0.011	0.020
PolStb	0.0551**	0.016	-0.007
Req_qua	0.0317*	0.01*	0.014*
Cons	0.142***	0.115***	0.111***

0.001 significance=\*; 0.05 significance=\*\*; 0.01 significance=\*\*\*

$$\text{CAR}_{ij} = 0.142_{ij} + 0.0551 \text{ Political stability}_{ij} + 0.031 \text{ Regulatory\_Quality}_{ij} + 0.691 \text{ CtoA}_{ij}$$

According to FRE results, as other variables are constant, a %1 increase in political stability causes a 0.0518 increase in Capital Adequacy Ratio (CAR), a %1 increase in regulator quality causes a 0.0416 increase in Capital Adequacy Ratio (CAR), a %1 increase in Capital to Asset Ratio causes to 0.708 increase in CAR (index). According to the research model, ROE, Control of Corruption, Government Effectiveness, and Political stability do not in a significant statistical relationship with Capital Adequacy Ratio. The robustness check is utilised on the dataset the following results are taken in Table 5. There is no endogeneity in the series according to the 2-stage least square (2SLS) regression.

Table 5. Robustness check

	Variable (Capital Adequacy Ratio)	
	Robust Regression	2SLS regression (for endogeneity)
ROE	-0.0037686	.0229064
Capital to Asset Ratio	0.6917081874***	.5799582***
Control of Corr	-0.029	-.0338444**
GovEFF	-0.0108	.0321175***
PolStb	0.055**	-.0135309**
Req_qua	0.0317**	.0111989
Cons	0.1385593***	.1095171

0.001 significance=\*; 0.05 significance=\*\*; 0.01 significance=\*\*\*

Al-Kayed et al. (2014) emphasized that there will be fixed claim liabilities on the Islamic Banks' balance sheets. Therefore, Islamic banks should operate under capital adequacy regulations, although theoretically, they should operate as having an equity-based capital structure. This research examines the relationship between Capital Adequacy Ratio (CAR), leverage and governance indicators. According to research results, the CAR value shows an increase with the increasing regulator quality, leverage and political stability however, there is no statistically significant relationship between Control of Corruption and CAR and Government Efficiency and CAR. Because of the variability of corruption scores and government efficiency scores in Islamic countries as in the works of Boudriga et al. (2009), Gambling and Karim (1986).

More generally, research findings carry similarities with Miah and Sharmeen (2014) that state capital and risk are expected to be associated positively. Furthermore, capital and risk are also influenced by the level of efficiency of a bank. Regulators likely allow an efficient bank with better management to use more leverage than an inefficient bank. On the other side, it is another interesting finding of this research that there is not an important relationship between ROE and CAR. Conversely, Masood and Ashraf (2012) state that there can be a relationship between ROE and ROA measures with capital structure and CAR. The main causes of the unconformity can be different cultural and socioeconomic factors. Wijaya et al. (2021: 30) find that good corporate governance and capital adequacy affect financing risk, and good corporate governance, capital adequacy, and financing risk affect profitability in Islamic Banks.

Another important emphasis of their work is the existence and impacts of Islamic Social Reporting (ISR) on these variables. Again and again, the findings of this research can shed more light on CAR for Islamic banks. Pellegrina (2008) explains this situation and infers the reluctance that has accompanied the proposal of capital adequacy ratios for Islamic banks in accordance with Basel Agreements. Accordingly, it should be an important indicator that capital adequacy is a determinant of assessing bank performance with asset quality, management quality, earnings, and liquidity also for Islamic Banks (Hassan and Bashir, 2003).

The emerging prominence and systemic importance of Islamic banking in many Muslim countries, especially in Malaysia and the Gulf Cooperation Council (GCC) countries has stimulated much interest in its financial and economic roles (Ibrahim, 2020). Another important evaluation comes from the paper of Karim et al. (2022), Islamic banking is not only a profit-oriented organization, but It is also believed a society-benefiting industry. Moreover, Islamic banking should try to socialize and pursue social outcomes from their financial activities (Hamidi and Worthington, 2020), therefore good governance measures as some special indicators can be beneficial, and the second utilizable one can be financial innovations and fintech (Oladapo et al, 2020) and lastly, the Islamic Banking Industry should not miss the sustainability opportunities (Muhammad and Nugraheni, 2022). Manasseh et al. (2022) and Offori and Asongu (2021) confirm a similar relationship for other industries which realize external trade.

At the end of the analysis, it can be said that this research makes a contribution to Islamic finance research by a model that investigates the impacts of governance variables and leverage ratios in one model. The addition of the United Kingdom to the research sample, where the investors often confront Islamic Financial Instruments through Islamic Banking activities makes the research more interesting in light of this argumentation. The research model can be carried to the next chapters by the addition of the other countries to the research dataset.

## **Conclusion**

This study has explored the relationship between Capital Adequacy Ratio (CAR) and several governance and leverage-related variables within Islamic banks across thirteen Muslim-majority countries and the United Kingdom. Through panel data analysis, the findings indicate that regulatory quality, political stability, and capital-to-asset ratio are

positively and significantly associated with CAR, while other governance indicators such as control of corruption and government effectiveness, as well as return on equity (ROE), do not exhibit statistically significant influence in the fixed-effects model.

These results underscore the critical role of institutional and regulatory quality in enhancing the financial soundness of Islamic banks. Particularly, the significant impact of political stability and leverage suggests that systemic factors and financial structure continue to shape capital adequacy levels. While ROE is often associated with performance, its lack of significance in this model invites further investigation, possibly linked to differences in bank size, operational contexts, and socio-economic structures in the sampled countries. In addition to confirming and complementing earlier empirical studies, this research highlights the importance of adapting international banking regulations such as Basel standards to the specific operational and risk profiles of Islamic financial institutions. Given the increasing global footprint of Islamic banking, the results advocate for a more tailored regulatory approach that aligns with Sharia-compliant practices and financial realities in diverse jurisdictions.

While this study adds to the growing discourse on Islamic finance and governance, it is not without limitations. Data availability—especially for nuanced governance indicators such as transparency, board independence, and social responsibility—remains constrained. Future research may benefit from incorporating these dimensions and expanding the dataset to include additional years and countries. Moreover, investigating the interaction between digital innovation (e.g., fintech adoption) and capital adequacy may offer a promising avenue for understanding the evolving landscape of Islamic banking in the digital age. In conclusion, strengthening governance mechanisms and ensuring alignment with capital adequacy requirements are essential not only for risk mitigation but also for sustaining the trust and long-term growth of Islamic financial institutions in both Muslim and non-Muslim countries.

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