02-02-TIBSS-6631-1216

International Journal of
Trends and Innovations in Business & Social Sciences
Vol. 4 No. 1 (March, 2026) | 13 - 26
ISSN (e): 2959-4634 | DOI: https://doi.org/10.48112/tibss.v4i1.1216

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Revisiting Audit Quality and Bank Stability: Insights from Islamic and Conventional Banking in MENA

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ARTICLE INFO

Article history:

Received: January 04, 2026
Accepted: March 23, 2026
Accepted: March 28, 2026
Published: March 31, 2026

Keywords:

Audit Quality
Bank Stability
Conventional Banking
Islamic Banking
MENA
Political Turmoil

ABSTRACT

The purpose of this study was to examine the impact of political turmoil, bank characteristics, and audit quality on the financial stability of banks in terms of Z-Score. This study employed the fixed and random effects models on the whole sample, Islamic banks, and conventional banks, respectively. The total panel observation of this paper was 2,873 from 221 institutions. The findings showed that although audit quality positively affects conventional banks, it negatively affects the stability of Islamic institutions to a significant extent. The result also highlighted the positive relationship between financial stability and other explanatory variables such as bank size, profitability, liquidity, and the Capital Adequacy Ratio (CAR) in all models. However, leverage had a negative impact on financial stability except in the Islamic banks context, where a positive correlation existed between leverage and financial stability. Political instability was a major cause of financial instability in any model, although it affected the Islamic institutions the most. In the Islamic bank's context, the random effects model was most appropriate, while the fixed effects model was suitable for the entire sample comprising regular banks. These results provide regulators and policymakers with special recommendations on how to make banks more stable in different banking conditions.

INTRODUCTION

One of the pillars of the financial system resilience and sustainable economic development is the stability of the banking sector. Banks are financial intermediaries that help to channel savings into productive investment and provide liquidity in the economy (Levine, 2005). However, banking systems are vulnerable by nature because of leverage, maturity transformation and exposure to systemic shocks. The global financial crisis and resulting regional instabilities have increased scholarly and regulatory focus on mechanisms to

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How to Cite:

Ayub, H. M., Rashid, A., Butt, S., & Chohan, M. A. (2026). Revisiting Audit Quality and Bank Stability: Insights from Islamic and Conventional Banking in MENA. *International Journal of Trends and Innovations in Business & Social Sciences, 4*(1), 13–26. https://doi.org/10.48112/tibss.v4i1.1216

enhance bank stability. The financial soundness is crucial in order to protect the confidence of depositors and avoid the contagion effects on the financial markets in conventional and Islamic banking system. The bank level financial stability is typically reported in the form of the Z-score that quantifies the insolvency distance by summing up the profitability, leverage and volatility indicators (Lepetit & Strobel, 2015). Z-score has been popularized in comparative studies as it is a measure of risk-bearing capacity and capital buffers between Islamic and conventional banks. In emerging regions such as MENA, where political and macroeconomic volatility are common, studying the determinants of bank stability is even more important.

Audit quality plays an important role in increasing financial transparency, decreasing information asymmetry, and improving regulatory compliance as discussed by Tobing et al. (2024). In order to increase the effectiveness of monitoring and increase the credibility of financial reporting, the audit quality represented by Big 4 auditors, audit committee size, audit committee meetings, independence of audit committee, gender diversity, and co-audit structure. Recent literature considers audit quality to be a factor of resilience in the system, in terms of curtailing earnings manipulation and enhancing disclosure of risks (Kyriakou, 2022). In addition to governance, internal bank factors, including size, growth, leverage, liquidity, profitability, and Capital Adequacy Ratio (CAR), play a major role in determining the result of stability (Demirguc-Kunt et al., 2022). Bigger banks can possibly exploit diversification and economies of scale, and high leverage can increase the risk of insolvency. Capital adequacy is a major shock absorber under Basel III regimes. The interplay between the governance mechanisms and the bank fundamentals is thus very important for understanding the dynamics of financial stability.

The MENA region offers a particular institutional context as a result of recurrent political instability in countries such as Egypt, Syria, Yemen, Iraq and Tunisia. Political instability increases the degree of uncertainty and decreases the resilience of the banking sector and institutional enforcement (Boubakri et al., 2023). Islamic banks response towards the asset-backed and profit-sharing structure might be different to such shocks than the conventional banks. Hence, political risk becomes a key contextual variable that affects financial stability. This study contributes to literature in four ways. First, it jointly examines audit quality, bank-specific characteristics, and political turmoil within a unified framework to explain bank financial stability in 18 MENA countries. Second, it compares Islamic and conventional banks and provides structural insights into the operation of governance mechanisms under different banking models. Third, it uses recent techniques of panel estimation with Hausman specification testing to ensure model robustness across sub-samples. Finally, by incorporating political turmoil in the governance stability nexus, the study goes beyond firm-level outcomes to systemic financial stability implications of audit quality literature.

Objective of the study

- To investigate the impact of audit quality on financial stability of Islamic and conventional banks in the MENA region.

Research Question

Based on the objectives of the study, this research work addresses the following research question:

- How audit quality impacts the financial stability of Islamic and conventional banks in the MENA region?

LITERATURE REVIEW

The audit quality is significant in enhancing the financial stability of banks through ensuring that financial reporting is more accurate and lacks any information asymmetry between bank managers and stakeholders. Premium quality audits improve monitoring systems and decrease the potential of manipulating the earnings, thereby decreasing the chances of insolvency. It is empirically proven that good audit committee arrangements play a major role in determining the bank stability results (Fariha, et al., 2022). In addition, there is enhanced external audit supervision that enhances transparency and market discipline particularly where banking sectors are highly regulated. It has also been demonstrated that audit expertise contributes to the more precise evaluation of going concerns and prompt identification of risks (Ruiz-Barbadillo, et al., 2004). Thus, audit quality is a fundamental governance

tool that promote the financial sustainability and maintains banks performance in the long run. Audit committee independence also provides an oversight towards financial reporting and internal controls that ensures greater governance in the banking system. The independent members are not so much influenced by managerial pressure and they are better placed to defend the interests of shareholders.

It has been proved that the independent audit committees are linked to the enhanced stability of the bank and minimized the risk of financial distress. In addition, institutional settings contribute to the beneficial effect of governance systems on stability (Masyk, et al., 2023). The independent committees are also known to enhance the quality of disclosures and decrease risk taking behavior in the banks. This means that financial strength of banking institutions depends on audit committee independence. The effectiveness of monitoring and oversight in banks is influenced by the audit committee size. The committee of a moderate size is able to provide a range of expertise that will improve financial supervision and risk assessment. It has been found that proper committee structure, including optimal size positively influences the stability of the bank (Masyk, et al., 2023). Nevertheless, committees that are excessively large might have coordination problems that reduce efficiency. The governance structures also have an interaction with the quality of institutions to achieve the results of financial stability. Consequently, the size of the audit committee, which is well structured, facilitates accountability, improved risk management and the overall performance of the bank.

The gender diversity in audit committees fosters quality of decision making and ethical control. Multiple boards will be more cautious in the risk profile and surveillance capabilities. Empirical evidence proves that the greater the number of governance characteristics diversity, the greater the financial transparency and stability (Fariha, et al., 2022). Gender-diverse committees also assist in reducing the earnings manipulation and promoting more responsible risk-taking behavior. Also, diversity of governance has positive effect on institutional performance, particularly in emerging economies. Therefore, the gender diversity positively influences the effectiveness of governing and the financial sustainability of the bank. The financial stability is twofold in the bank size. The big banks are diversified and they have better access to funding sources which assist in enhancing the shock absorption capacity. Nonetheless, it is also possible to have large institutions increasing systemic risk due to interconnectedness. The size of the bank, according to research, is involved in the stability of the economic policy uncertainty in the interaction with the regulation capital and liquidity buffers (Shabir, et al., 2021). Also, the size of banks is a crucial determinant of profitability and efficiency dynamics, which determine the stability (Gržeta, et al., 2023). Thus, the stability impact of the size of banks depends on the free risk management mechanisms and the regulatory environment.

Leverage is a measure of the extent to which the banks finance their activities through debts relative to equity capital. Increased leverage exposes one to financial shocks and it also exposes one to insolvency. The regulatory bodies have been emphasizing on the stricter capital requirements to mitigate the leverage-based systemic risks (Singer, 2004). It is also empirically proven that there is an interaction between leverage and uncertainty in economic policies and that this is also relevant to the stability outcome of banks (Sang et al., 2021). Excessive leverage translates to a low financial strength particularly in periods of macroeconomic crisis. Therefore, prudent leverage ratios are necessary to ensure the bank solvency and long-term stability. The bank stability is hinged on liquidity management since it defines the capacity of the institution to cover the short-term liabilities. There are sufficient liquidity buffers to enhance the resilience to market shocks and financial distress. The studies prove the fact that both liquidity and capital play their role in the attainment of better results in the aspects of stability (Acosta-Smith et al., 2026). But a big liquidity hoarding can lead to a decline in profitability and efficiency (Barbakadze, 2024). The interaction of liquidity and macroeconomic uncertainty help in determining the dynamics of the stability. Hence, the management of liquidity is highly sensitive in order to maximize the financial performance without jeopardizing the institutional soundness.

Capital adequacy is the ability of bank to absorb unforeseen losses and continue as a solvent bank. Higher capital ratios are always related to better financial stability and performance during economic crises (Acosta-Smith, et al., 2026). Well capitalized banks are more resilient and maintain their lending activities during downturns. Furthermore, capital buffers make a country less vulnerable to systemic risk and improve the regulatory compliance under Basel III standards (Sang et al., 2021). The combination of capital and liquidity increases the ability of banks to resist macroeconomic shocks. Thus, capital adequacy

is one of the fundamental pillars of banking stability. Profitability reinforces internal accumulation of capital and increases a bank's ability to absorb financial shocks. Banks with higher Return on Assets (ROA) tend to have higher stability indicators. Presumably, there is evidence suggesting the interaction between profitability and liquidity management as well as economic policy uncertainty in determining stability outcomes (Sang et al., 2021). Higher earnings allow for internal buffers that make one less dependent on external financing. Sustainable profitability therefore helps in providing a long-term financial resilience and risk mitigation. Consequently, profitability is a fundamental determinant of banking sector stability.

Despite extensive research on audit quality and bank performance, three important gaps remain. First, previous research is mainly focused on developed economies, with limited comprehensive evidence from politically volatile MENA countries. Second, existing literature often considers governance variables in isolation and does not bring together audit quality, internal bank characteristics and political turmoil in a unified framework of stability. Third, comparative evidence between Islamic and conventional banks under political stress remains underexplored, especially based on recent post-IFRS adoption panel data. Addressing these gaps is key to enhance the relationship between governance structures and institutional risk and its impact on the financial stability of banks.

Hypotheses

There is a significant relationship between Big-4 firms and financial stability.

There is a significant association among Co-Audit and financial stability.

There is exist a significant relationship between independent non-executive directors and financial stability.

There is a significant association among audit committee's size and financial stability.

There is exist a significant relationship between ACM and financial stability.

There is a significant association among ACD and financial stability.

Is there any relationship exist between growth and financial stability?

Is there any relationship exist between liabilities and financial stability?

There is exist a significant relationship between profitability and financial stability.

There is a significant relationship exist between liquidity and financial stability.

There is a significant association among CAR and financial stability.

There is exist a significant relationship between Political Turmoil and financial stability.

METHODOLOGY

Data and Sources of Data

The study used panel data of conventional and Islamic banks operating in 18 MENA countries including Palestine, Egypt, Algeria, Tunisia, KSA, Jordan, Lebanon, Morocco, Syria, Iraq, Libya, Iran, Yemen, Oman, UAE, Bahrain, Kuwait, and Qatar. This study considers 2010 as the beginning year since Islamic financial institutions had adopted IFRS, guaranteeing consistency in financial reporting, and the sample spans 13 years, from 2010 to 2022 (Klish et al., 2022). The chosen nations, which are representative of the region's largest banking markets, were picked on the basis of their credit scores, banking assets, and banking industry development (Awad et al., 2024; Lassoued et al., 2016). It is also appropriate for comparative study because of the region's high concentration of Islamic banks. To guarantee dependability and data consistency, banks with inadequate financial or audit-related data during the study period were disqualified. Furthermore, in order to preserve generalizability, a minimum of four banks per nation were needed (Abdelsalam et al., 2016). Following the aforementioned criteria, 221 banks 151 conventional and 70 Islamic with 2,873 imbalanced observations make up the final sample size. The DataStream and the annual reports of banks are used as the main source for data collection in this study. Table 1 exhibit the breakdown of banks by nation.

Table 1
Composition of Banks by Country

		Bank Type		Listing		Bank Ownership		Total
Economies	**Total**	**Conventional**	**Islamic**	**Listed**	**Unlisted**	**Foreign**	**Govt.**	**Obs.**
Palestine	07	04	03	02	05	06	01	91
Egypt	17	12	05	11	06	12	05	221
Algeria	06	06	0	0	06	04	02	78
Tunisia	08	08	0	06	02	06	02	104
KSA	17	12	05	10	07	15	02	221
Jordan	12	03	09	10	02	09	03	156
Lebanon	12	10	02	06	06	11	01	156
Morocco	05	05	0	04	01	01	04	65
Syria	09	05	04	07	02	08	01	117
Iraq	31	23	08	25	06	25	06	403
Libya	08	07	01	0	08	06	02	104
Iran	10	06	04	07	03	09	01	130
Yemen	04	03	01	0	03	02	01	52
Oman	12	09	03	07	05	09	03	156
UAE	19	14	05	18	01	10	09	247
Bahrain	17	07	10	12	05	15	02	221
Kuwait	15	08	07	11	04	12	03	195
Qatar	13	08	05	09	04	10	03	169
Total	221	151	70	145	76	170	51	2873

Note: *Obs shows observation; Govt shows Government*

The study used panel estimating techniques by employing Pooled OLS, fixed effects (FE), and random effects (RE) models to investigate the relationship among audit quality, bank features, political unrest, and financial performance respectively. Initially, the Hausman (1978) specification test is applied to choose between fixed and random effects model. Related to variables proxies, bank financial performance is determined by Return on Average Assets (ROAA), that is the dependent variable. The Big-4 auditor (Big-4), co-audit (Co-Audit), audit committee independence (IAC), audit committee size (ACS), audit committee meetings (ACM), and audit committee gender diversity (ACD) are examples of the major independent variables that reflect audit quality and governance features. Bank size (Bank-S), growth (Growth), leverage (Lev Bank), profitability (Prof Bank), liquidity (LIQ Bank), CAR, and political unrest (PT) are examples of control variables that are unique to a given bank. Table 2 below provides comprehensive definitions and measurements of these variables.

Table 2
Variable, Definitions, and Measurements

Symbol	Definition	Name of variables
Big-4	External big Auditors	For Big -4 variable, the dummy (0 and 1) is used. 1 refers if a bank is audited by one of the Big-4 firms, otherwise 0.
Co-Audit	Co-operation of two audit firms	Co-audit is measured by dummy (0 and 1). 1 refers if a bank is audited by one of the Big-4 firms, otherwise 0.
IAC	Independence of audit committee	IAC is measured by audit committee members divided by independent non-executive directors
ACS	Audit Committee Size	For the measurement of ACS, the audit committee's size is taken as a proxy variable
ACM	Audit Committee Meetings	ACM shows the audit committee meetings held during the fiscal year
ACD	Audit Committee Gender	ACD is used to measure the diversity in audit committee which is calculated by taking the percentage of women on the audit committee.
Bank Size	Bank size	Bank size is measured by total assets natural logarithm.
Growth in total assets	Bank Growth	Bank growth is measured by taking the ratio of change in total assets and lag in total assets
Lev Bank	Leverage	Leverage refers as the ratio of total liabilities to total assets in the fiscal year
Prof Bank	Prof Bank	The ratio of net income to lag total assets is calculated to measure the profitability of bank.
LIQ Bank	LIQ Bank	The ratio of current assets and current liabilities is used to measure the liquidity of banks.
CAR	Capital Adequacy Ratio	CAR calculates the ratio of a bank's risk-weighted credit exposures to its available capital.
PT	Political Turmoil	PT is measured by dummy variable. If bank headquarter is located in Egypt, Yemen, Syria, Tunisia, or Iraq, a dummy variable is encoded with 1; otherwise, it is encoded with 0.

Note: *Bank specific variables (control variables)*

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Estimation Model

The following equation (Eq.) provides the empirical link between the independent variables (audit quality metrics and bank-specific traits) and dependent variable (financial stability). The equation model is estimated on the entire sample of banks and then on two sub-samples i.e., Islamic banks and conventional banks with the same specification.

$$ZScore_{ijt=}\ \beta_0+\beta_1 Big_{4ijt}+\beta_2 CoAudit_{ijt}+\ \beta_3 IAC_{ijt}+\ \beta_4 ACS_{ijt}\ +\ \beta_5 ACM_{ijt}+\ \beta_6 ACD_{ijt} + \beta_7 BankSize_{ijt}+\beta_8 Bankgrowth_{ijt}+\beta_9 Leaverage_{ijt}+\beta_{10} Profitability_{ijt}\ + \beta_{11} Liqudity_{ijt}\ +\beta_{12} CAR_{ijt}\ +\beta_{13} PT_{ijt}\ +f_j+f_i+f_t+\mu_{ijt}$$

Fixed Effects Model

Because it uses within-entity variation to assess the connection between the explanatory variables and the dependent variable, the fixed effects model is appropriate when the investigation involves variables that vary over time. By permitting correlation between the explanatory variables and the entity-specific effects, this method accounts for unobserved, time-invariant features that could influence the regressors. A better assessment of the impact of time-varying predictors on the outcome variable is thus made possible by eliminating from the calculation the elements that do not change over time. The fixed effects model assumes, among other things, that individual-specific effects are independent across entities and that unobserved heterogeneity fluctuates among entities but remains constant within entities across time. The Hausman test is used to support the preference for fixed effects over random effects when the error terms can be associated with the regressors. Fixed effects provide consistent estimates.

Random Effects Model

The random effects model is predicated on the idea that variations across entities are arbitrary and unrelated to the model's explanatory factors. To find out if cross-entity variation affects the dependent variable, this study uses the random effects approach. Since the model presumes that the entity-specific error term is independent of the explanatory factors, this specification has the significant benefit of permitting time-invariant variables as regressors. Under this framework, unobserved individual characteristics are viewed as randomly distributed across entities, as opposed to fixed. However, the random effects estimates could be biased by missing variables if pertinent entity-specific characteristics that are linked with the regressors are not included due to data restrictions.

Hauseman Test

Hausman test introduced by Hausman (1978) which is used to decide whether the study apply fixed effects or a random effects estimator. The test is employed to compare the consistency of the two estimators to establish whether the individual specific effects are correlated with the explanatory factors. Both fixed effects and random effects estimators are consistent under the null hypothesis, but the random effects estimator is preferred because it is more efficient. The random effects estimator is not appropriate since it is only the fixed effects estimator that is consistent under the alternative hypothesis. Random Effects (RE) and Fixed Effects (FE) estimators appears in two hypotheses. In the event that H_0 is true (no correlation between individual effects and regressors), both RE (b_1) and FE (b_0) are consistent, but RE is more efficient; in the event that H1 is true (correlation exists), RE is inconsistent and FE is consistent and efficient, and hence FE is preferred in that case.

RESULTS & DISCUSSION

Descriptive Statistics

Table 3 presents the descriptive analysis of the whole sample. The research provides the descriptive statistics findings of the traditional banks and the pooled data of the Islamic banks. The Z-Score, which is a measure of financial stability, has a mean of 17.1 and a standard deviation of 5.8, which is highly dispersed. The distribution is skewed (0.9) with a kurtosis of 3 indicating a slightly left-tailed distribution with near-normal properties. The standard deviation of the Audit Quality Index is 0.8 with a mean of 0. It is slightly platykurtic but relatively symmetrical as the skewness of -0.6 and kurtosis of 1.7 show. The

mean of Bank Size is 18.745 and the standard deviation is 3, skewness is 0.3 and kurtosis is 2.8, which indicates a near-normal distribution. The mean of 0.1, standard deviation of 0.1, skewness of 0.7 and high kurtosis value of 9.6 of Bank Growth indicate a right-skewed distribution with extreme values. Compared to relatively regular, leverage has a mean of 0.1, a standard deviation of 0, a skewness of 0.2, and a kurtosis of 2.1. The mean of liquidity (3.2), standard deviation (1.6), skewness (0.4), and kurtosis (2.3) indicate a significantly right-skewed distribution. The mean of profitability of 4.2, standard deviation of 2.2, high skewness of 2.4, and kurtosis of 9.4 indicate a distribution with extreme positive values. The Capital Adequacy Ratios (CAR) mean of 0.2, standard deviation of 0, skewness of -0.06, and kurtosis of 1.8 indicate a near-normal distribution. The binary variable Political upheaval (PT) has a mean of 0.3, which means that approximately 34 percent of the sample observations are associated with political upheaval. The kurtosis of 1.46 and skewness of 0.7 indicate a slight right-skew.

Table 3

Full Sample Data: Descriptive Summary

Variables	Obs	Mean	Std.Dev.	Min	Max	Skew.	Kurt.
Z-Score	2873	17.1	5.8	2.0	25.3	-0.9	3
Audit Quality Index	2873	0	0.8	-1.5	1	-0.6	1.7
Bank Size	2873	18.7	3	10.9	27.9	0.3	2.8
Bank Growth	2873	0.1	0.1	-0.9	0.9	0.7	9.6
Leverage	2873	0.1	0.04	0.03	0.2	0.2	2.1
Liquidity	2873	3.1	1.6	0	7.3	0.4	2.3
Profitability	2873	4.2	2.2	1.5	14.8	2.4	9.4
CAR	2873	0.2	0.06	0.04	0.3	-0.07	1.9
PT	2873	0.3	0.5	0	1	0.7	1.5

Correlation Analysis

The audit quality index and the variable earnings management have a strong association (-0.796), meaning that the higher the audit quality, the lower the earnings management level. This suggests that banks would have lower returns the more they managed their earnings, which would have a detrimental effect on their overall profitability. Also, the net profit margin (-0.361) has a moderately negative correlation with the earnings management. This implies that the banks that have the most aggressive earnings management strategies will have lower returns, which would be unfavorable to their overall profitability. There is a negative link between EM and returns on equity (-0.269) and returns on assets (-0.344). This suggests that banks' returns decrease with increasing degrees of earnings management, which has a detrimental effect on their total profitability. The relatively low correlation (-0.068) between it and the Z-Score suggests that the management of earnings has no discernible impact on the Z-Score's estimate of the company's overall financial health. This may suggest that other factors are more important in determining financial stability.

In addition, NPM (-0.064) and ROA (-0.065) have weak correlation with the bank size, signifying that bigger bank might be experiencing a lower level of profitability indicators. Bank growth and EM have a negative correlation (0.273), which implies that the faster the bank grows, the less likely it is to practice earnings management. Due to their positive relationships with EM, banks that have greater leverage and liquidity can practice earnings management. In the same way, there is a moderately positive correlation between EM and profitability (0.164), indicating that the higher the profits, the higher the earnings management practices of a bank. The capital adequacy ratio is negatively correlated with ROE (-0.557) and ROA (-0.656) and positively correlated with EM (0.323). This finding raises the possibility that banks with greater capital may be managing earnings, which might hurt their bottom line. The negative correlation between Political Turmoil and EM (0.009) suggests that political considerations do not significantly affect the sample's earnings management.

Regression Results

The results are presented in table5. The findings evaluate the bank stability determinants by using Z-Score of whole samples (including Islamic and conventional banks), Islamic banks sample, and

Conventional banks sample. There is inverse relationship between Z-Score and bank risk. Thus, increase in score showing that bank is stable, however, lower score demonstrates the bank is riskier. Audit quality shows positive but insignificant impact (0.0384) on bank stability implies no clear effect on the stability of the banks. In Islamic bank samples, audit quality and Z-Score are negatively and significantly related (-0.379), signifying that the higher the quality of audit, the lesser the Islamic banks stability. The result shows that there is a stricter regulation requirement on Sharia compliance that leads to a limitation of operations and increased costs that may destabilize banks. The stability of conventional banks is positively and significantly related to audit quality (0.306). In the case of traditional banks, better quality of audit can contribute to financial stability by enhancing transparency and minimizing misreporting, which is in line with Agency Theory. The negative association emphasized that audit quality would not have an immediate stabilizing effect due to regulatory complexities and Shariah standards of compliance in the context of Islamic banks. The result is consistent with the study by Saragih (2017), which has shown that higher quality of audit is usually associated with stability through reduction of risks. Nonetheless, the difference in the impact on various kinds of banks suggests that the regulatory and working arrangement can mediate this interaction.

Audit quality and conventional bank stability have positive relationship that are similar with the study of Barth et al. (2004). The study emphasizes the transparency significance in risk-mitigating. In addition, quality audits are significant in financial stability because they increase investor confidence and market integrity through providing more reliable financial statements. Detecting anomalies and threats in finance at an early stage, thorough audits can contribute to reducing systemic risks in the banking sector. Good audit controls play an important role towards the financial stability in financial uncertainty concept. Moreover, Z-Score has positive association with bank size in all samples with the coefficient of 1.054, 0.776 coefficient of the Islamic banks, and 0.818 coefficient of conventional banks. The larger banks tend to be more diversified and can absorb the financial shocks and are therefore more stable. The concept is similar with the "Too-Big-To-Fail Theory", whereby bigger banks are advantaged by implicit government bailout during a crisis. This finding was supported by previous studies by Adusei (2015) which revealed that bigger banks have a higher chance to be more financially stable due to diversification and access to a larger number of resources.

The correlation between the size of banks and their stability is justified by the research like that of Laeven et al. (2014) that identifies that bigger bank has a greater systemic risk. Different research also conjured with this study, as it highlighted the relationship between bank size and the financial stability of European financial institutions. Although their regulatory scrutiny is increased, the bigger banks are observed to be more stable during economic crises as a result of their diversification and capital market accessibility (Pais & Stork, 2013). It is discussed how bigger banks affect the stability of the emerging market economies in the sense that the bigger the banks in these regions are prepared to absorb the shocks, they do caution of increased systemic risk (Demirguc-Kunt et al., 2022).

Additionally, banks stability has a negative effect on the banks growth in the full sample with a significant coefficient of (-0.919), implying that the growth rate can be unstable as a result of the risks involved in the growth. In addition, Islamic banks coefficient has a strong negative connection with coefficient (-2.785), inferring that the high growth of Islamic banks has a noteworthy effect in reducing their stability. This shows that the Islamic banks are struggling to manage their expansion and comply with the Sharia principles that heighten the operational and financial risks. The conventional banks coefficient is -0.514 assessing that bank growth has no clear impact on the stability of the banks and hence the conventional banks are at a better position of managing the growth without influencing their stability. The high growth can cause over-leveraging and taking risks that can make the company less stable financially. This follows the Growth-Instability Hypothesis which argues that excess growth when poorly managed can result in financial instabilities. The authors claim that aggressive expansion policies, especially in the financial institutions, could destabilize the banks as they posed more risky asset portfolios and leverage (Laeven & Levine, 2009).

The study that has examined that the expanding banks have affected the financial stability of the Euro Area has confirmed us to be right. According to Ongena et al. (2019), the lack of financial stability may stem from the emergence of banks at a rapid rate, their propensity to take risk, and the reduction in capital buffers. In addition, another research provides support to our findings and show relationship

between the financial stability of the developing countries and the development of banks. It also implies that moderate growth is expected to lead to a higher financial stability thanks to the higher efficiency and access to credit, and that extreme growth may lead to instability (Carletti et al., 2002). Haldane and May (2011) conclude that both organic and inorganic bank growth have an impact on global financial stability. In addition, mergers and acquisitions are risky when it comes to integration, and organic growth, which is achieved through the increased lending and asset accumulation can result in the increased stability.

The negative and significant impact of leverage on full sample (-3.976) implies that the greater the leverage, the greater the risk and the less stable the banks. This is in line with financial theory according to which the more leveraged institutions are the more vulnerable they are to financial shocks. Interestingly, leverage has a positive and significant with coefficient (29.2) impact on stability of Islamic banks. The findings implies that the specific capital structure of the Islamic finance that uses less leverage, and it is organized in a different manner, which is less risky. The adverse leverage impact is significantly more negative on conventional banks (-6.440), which implies that the traditional types of leverage in conventional banks significantly lower the stability, consistent with the banking literature. The adverse effects of leverage on the traditional bank's stability are in line with the findings of Gornall and Strebulaev (2018), which concludes that increased leverage ratios place banks at increased risks of default.

The leveraging in conventional banks increases the risk of insolvency and this is in line with the Trade-Off Theory that indicates that high debt increases financial distress. Leverage, however, is not so risky in Islamic banks, where in most cases the financing is asset-backed. Valencia (2014) also discovered that leverage and bank stability have negative impacts in traditional banks. Whereas, leverage can be more predictable due to its compliance with the principles of Shariah in Islamic banks, as similar by the study of Beck et al. (2013) on Islamic finance. Similar results study shows the connection between the bank leverage and European banking system stability. It emphasizes the need for more stringent capital standards and comes to the conclusion that the danger of bank failures and systemic crises increases with leverage levels (Acharya et al., 2012). The relationship between leverage and the financial institutions strength was also explored in another research. Their primary argument is that the larger the institutions are in debt, the more vulnerable they are to shocks, and the broader the economic consequences (Kashyap et al., 2002). Another study that investigated the fact that too much household leverage can significantly harm financial stability, as it increases the risk to defaults and decreases the economy in general, confirms our findings. The study demonstrates that leverage and financial stability have strong relationship in terms of household debt (Gropp et al., 2019).

Liquidity has a beneficial impact on the Z-Score of the entire sample (0.406) and conventional banks (0.533), but this effect is not statistically significant for Islamic banks. More liquidity suggests that banks are more stable and less likely to default because they can better meet their short-term obligations. However, Islamic banks might not have the same type of liquidity advantage due to the few Shariah-compliant liquidity management instruments at their disposal. According to Ghenimi et al. (2017), liquidity positively correlates with the stability of the bank since liquid banks are more in a position to manage the unforeseen withdrawal and financial shocks. This observation is congruent with the latest studies that emphasize the role of liquidity in alleviating risks during financial distress. The research established that the impact of liquidity on the financial stability of banking sector. As banks with sufficient amounts of cash in their hands are more capable of absorbing temporary shocks and reducing the risk of becoming bankrupt, the study finds that high levels of liquidity result in greater financial stability (Chen et al., 2021). Similar findings are also in line with the research, which investigated the role of liquidity in enhancing the bank finances in the United States. According to the author, the bigger the cash buffers of financial institutions, the more they can endure economic storms and continue to keep their doors open (Berrospide et al., 2016). Our study was validated by another study that examined the effect of liquidity risk management on the soundness of the finances of the European banks. It demonstrates that not only the economic stability and the ability to withstand market shocks but also the financial health of banks is improved in this case when the risk management procedure is performed well (Li et al., 2020).

The profitability has a positive impact on the Z-Score in all the samples with coefficients of 0.219 in the full sample, 0.290 in Islamic banks and 0.209 in conventional banks. Stability is achieved as a result of increased profitability since there is a buffer against losses that can boost capital reserves. This is consistent with Profitability Theory where profitable banks are more stable because of capacity to

reinvest income and withstand financial shock. Menicucci and Paolucci (2016) agree that profitability positively affects the stability of the bank, as stable income enhances financial stability. The researchers discovered the relationship between the successful financial markets and profitable banks in Europe. The research emphasizes the role of profitability as the key to financial stability by finding out that it is linked to a lower risk of bank failures and systemic crises (Menicucci & Paolucci, 2016). The paper in the case of Greek banks considered the relationship between profitability and financial stability. The study demonstrates that financial stability is enhanced through enhanced profitability, which allows absorbing losses and ensuring capital adequacy.

The capital adequacy ratio has a high positive impact on the Z-Score of the full sample, 7.448, Islamic banks, 8.402, and conventional banks, 7.686. Having a high CAR means that banks possess a good capital base that makes them more stable in the sense that they serve as a buffer to any losses occurring. This is in support of the Capital Buffer Theory which argues that the greater the capital base, the less likely the company will fail in a financial crisis. Similar findings were made by Tran et al. (2022), who demonstrated that banks that are better capital-adequate are resilient to financial instability. This is particularly the case in Islamic banking, where the capital requirements are very strict to guarantee Shariah compliance. Sang et al. (2021) discovered that the Capital adequacy and its impact on the stability of banks in Vietnam. It concludes that better financial stability correlates with better CARs because such ratios minimize the chances of bankruptcy and serve as an insurance against loss. The findings are in line with the research, which investigated the issue of capital adequacy in the security of developing market banks. Their findings make them assume that banks are in a better position to survive economic storms when CARs are high enough (Alexandridis & Hasan, 2020). The results of our study were confirmed by another study, which observed correlation between CAR and bank stability in Europe. Banks that have a high CAR are more resistant to losses and can sustain the confidence of people in the financial system and, therefore, to financial crises.

The bank stability of full sample is -2.665, which is strongly and negatively affecting the political turmoil, meaning that bank risk is severely influenced by political turmoil. This is consistent with the recent literature that demonstrates the impact of political uncertainty on the financial markets and the financial risks exposure on the financial institutions. The impact of political turmoil on the stability of the Islamic banks is even more significant (-3.705), which may be explained by the fact that Islamic banks are more susceptible to the change of geopolitical and regulatory factors. Political turmoil has also a negative effect but is not as large (-1.532), indicating that conventional banks are a bit more resistant to political risks, which may be attributable to more diversified business. The high adverse effect of political instability is comparable to the findings of Al-Shboul et al. (2020), who discovered that financial institutions in politically instable countries have more difficulties in ensuring stability.

Economic uncertainty that comes with political instability interferes with the operations of the banks, and can lead to a reduction in the stability by heightening credit and operation risk. This is particularly useful with the case of the Islamic banks that may be facing additional regulatory scrutiny in the unstable political settings. This is in line with the Institutional Theory, according to which external forces, like political instabilities, disrupt economic stability and put at risk, thereby reducing financial stability. Research by Ademe (2023) has found out that political instability tends to lead to reduced financial stability due to the heightened regulatory uncertainty and operational risk to banks. The findings are consistent with the research, which examined the impact of political risk on the financial stability of developing markets. Because political uncertainty may lead to capital flight, exchange rate volatility, and lower investment, one can conclude that the higher the political unrest, the more financial instability (Bekaert et al., 2016). Our findings were also supported by another research that was conducted on the impact of political unrest on the financial system of a group of nations. The outcome was that political unrest such as violent conflicts or frequent changes of government negatively impacts financial stability since it leads to financial uncertainty and financial institutions being destabilized. The research also aligns with the results, which investigated how the political instability of developing countries affects the stability of the banking sector in the countries. It concludes that political instability undermines financial stability as it makes non-performing loans more frequent and reduces the profitability of banks.

Table 5
Regression Results for the Baseline Model for Financial Stability

Variables	Z-Score (Fixed Effect Model) Full Sample	Z-Score (Random Effect Model) Islamic Banks	Z-Score (Fixed Effect Model) Conventional Banks
AUDQINDX	0.0384	-0.379**	0.306**
	(0.102)	(0.156)	(0.132)
BANKSIZE	1.054***	0.776***	0.818***
	(0.139)	(0.169)	(0.170)
BGROWTH	-0.919*	-2.785***	-0.514
	(0.538)	(0.912)	(0.661)
LEVBANK	-3.976**	29.42***	-6.440***
	(1.759)	(4.586)	(2.245)
LIQDTY	0.406***	0.106	0.533***
	(0.0768)	(0.0725)	(0.0927)
PROFTB	0.219***	0.290***	0.209***
	(0.0418)	(0.0782)	(0.0500)
CAR	7.448***	8.402***	7.686***
	(1.183)	(1.959)	(1.458)
PT	-2.665***	-3.705***	-1.532*
	(0.220)	(1.403)	(0.849)
Constant	39.76***	35.52***	35.69***
	(2.476)	(2.975)	(3.083)
Observations	2,873	910	1,963
R-squared	0.533	0.570	0.551
Number of BID	221	70	151
Hausman Test(χ^2)	141.77 (0.0000)	5.65 (0.5806)	67.19 (0.0000)

Note: *Standard errors (S.E) in parentheses ( ). *** shows p<0.01, ** shows p<0.05, * shows p<0.1*

CONCLUSION

The findings of this study highlighted the different patterns in banking structures. The result showed a negative relationship between audit quality and financial stability of Islamic banks, suggesting underlying risks due to increased scrutiny, whereas it increased stability in conventional banks. Bank size, profitability, liquidity, and CAR had a positive contribution to financial stability in all models, suggesting that well-capitalized and profitable banks were more resilient. Conversely, the result identified that leverage and financial stability had negative association by taking the entire sample and conventional banks, but has a strong positive impact in Islamic banks, possibly because of the unique financial structures of Shariah-compliant institutions. Political turmoil is a significant determinant because of lack of financial stability in all cases, but the impact is most pronounced in Islamic banks. This points to the increased vulnerability of these institutions to external economic and political shocks. The study also highlighted that Hausman test confirm the fixed effect model appropriateness for entire sample and conventional banks. While, the random effects model results are preferred specifically for Islamic banks. Overall, the findings of this paper highlight the significant feature of developing specific regulatory strategies to improve bank stability. In the development of risk management framework in an economy, there is a dire need that policy makers should take into account the different structure of Islamic and conventional banks. Strengthening capital buffers, better liquidity management and reducing the negative impact of political turmoil can help to create a more stable banking sector.

Policy Implication and Recommendations

Considering the diverse and complicated economic and regulatory frameworks in the MENA area, the relationship between audit quality and financial stability is of utmost importance, especially for the banking industry. Accurate financial reporting, strong internal controls, and regulatory compliance are the three pillars upon which conventional and Islamic banks rest when audits are conducted to a high

standard. The following are the policy ramifications. Making sure that auditors don't work for anybody else and don't have any conflicts of interest so they can provide you honest opinion. Establishing and maintaining stringent audit standards that encourage comprehensive and efficient auditing procedures. Promoting ongoing education for auditors so that they can keep up with changing auditing standards, technology, and procedures. Banks should put in place robust governance frameworks and internal procedures to ensure high-quality audit. To make sure audits are up to par and find places to improve, regulatory bodies should examine audit quality on a regular basis.

Competing Interests

The authors declared no competing interests.

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