



## The Relationship between Corporate Governance, Financial Performance and Financial Stability: Case of Islamic Banks of GCC Countries

Zaineb Bououn<sup>a,\*</sup> , Wissem Benali<sup>b</sup> , and Jamel Eddine Mkadmi<sup>c</sup> 

a. Institute of Higher Commercial Studies of Sousse, Sousse 4000, Tunisia.

b. ESCT, University of Manouba, LARIMAR, Manouba, Tunisia.

c. Higher institute of business administration of Gafsa, Gafsa, Tunisia.

\* Corresponding author.

Received: 20 May 2024, Revised: 19 July 2024, Accepted: 22 August 2024, Published: 30 September 2026

Publisher: The University of Tehran Press.

©Authors retain the copyright and full publishing rights.

### Abstract

This study investigates the stability issues of Islamic banks (IBs) in Gulf Cooperation Council (GCC) countries, with a particular focus on the relationship between IB stability and corporate governance mechanisms. Utilizing the Z-score methodology and examining the impact of corporate governance variables on IB stability, the research aims to assess whether stability issues pose threats to all financial institutions in the GCC region. Unlike previous cross-country studies, this research concentrates on country-level data from Malaysia's banking industry, providing complementary insights into the emerging literature on Islamic banking stability. Employing a sample of 100 Islamic banks using the generalized method of moments (GMM), the study examines variables such as Shari'ah board size, board size, and independent directors alongside the Z-score as the dependent variable, aiming to provide a comprehensive understanding of the governance mechanisms influencing IB stability. The analysis underscores the complexity of the relationship between financial performance and stability, highlighting both positive and negative impacts. While high financial performance can enhance stakeholder confidence and governance effectiveness, it may also lead to behaviors undermining long-term stability, such as excessive risk-taking and moral hazard. The study also emphasizes the significance of financial stability measures, such as the Z-score, in assessing the health of financial institutions. In conclusion, the research contributes to the understanding of stability issues in Islamic banking and underscores the importance of effective governance mechanisms in ensuring the resilience of financial institutions in the GCC region.

**Keywords:** duality, governance, performance, size, stability.

**JEL Classification:** G34, L25.

### Introduction

Gaining a competitive edge in a knowledge-based, free-market economy is the goal of corporate governance. By leveraging all available resources, effective corporate governance can maintain this competitive edge. Good corporate governance practices ensure better decision-making, operational efficiency, and waste

reduction. Additionally, they balance the interests of both executives and non-executives (Shleifer and Vishny, 1997). Investors can have confidence that firms with sound corporate governance practices will distribute free cash flow to shareholders as dividends, rather than allowing it to be appropriated by insiders (La Porta et al. 2002).

According to Srivastava (2009), corporate governance is defined by legitimacy, responsibility, and competence in policy and service delivery while concurrently upholding the law and human rights. The Cadbury Report (Cadbury, 2002) provides a clear understanding of corporate governance by explaining how it controls and supervises businesses' operational activities. However, the effectiveness of governance can vary. It may be excellent or poor, effective or ineffective, depending on what is included in the governing procedures and the quality values associated with it.

Prior research has shown that well-governed businesses exhibit superior financial performance and market valuation, whereas poorly governed firms demonstrate worse operating performance (Shleifer and Vishny, 1997; Bebchuk et al., 2004). Companies with strong corporate governance practices not only provide their shareholders with additional rights but also offer more cash dividends. According to Arnott and Asness (2003), companies with superior governance distribute more cash to their shareholders. When examining the impact of corporate governance on a firm's performance in Pakistan, Javed and Iqbal (2006) conclude that effective corporate governance methods reveal poor management and low output through open disclosure and transparent standards. In a report on the reasons for the failure of rural community banks in Ghana, the Bank of Ghana (2001) notes that one of the reasons was an inefficient board of directors. In this context, sound corporate governance practices support societal well-being in general.

The role of corporate governance in the effective functioning of Islamic banks is crucial, given that these institutions are governed by the Sharia Board. The obligation of management to maximize shareholder wealth, as predicted by agency theory, while simultaneously being Shariah compliant, adds complexity to the issue of corporate governance in Islamic banks. Ghlamallah et al. (2021) regard corporate governance as a critical aspect of Islamic governance and morality, a reality long recognized by academics and practitioners in the market. This recognition inspired our study.

Both the size and number of Islamic banks have significantly increased in numerous countries around the world. Islamic banks (IBs) have experienced spectacular growth, particularly in the Middle East and Southeast Asia, although

their overall assets remain relatively small compared to global banking assets. The inherent risks associated with IBs have been the subject of several studies, but these are often approached from a theoretical perspective (Boumediene and Caby, 2009).

Furthermore, it remains unclear from these theoretical studies how and if the banking characteristics of IBs, such as their stability, differ from those of traditional banks.

Empirical research on this topic has not advanced as much as theoretical research. In the first empirical study on Islamic banking stability, Cihak and Hesse (2008) compared the stability of IBs to traditional banks by measuring it using an indicator of bankruptcy risk. This study has been frequently referenced in other empirical investigations, including those by Boumediene and Caby (2009). These studies utilized cross-country data collection. However, significant issues related to this methodology, such as the varying definitions of banks and distinct characteristics of the banking industry across different countries, should have been addressed more thoroughly. Additionally, differing financial systems that either support or restrict the operation of IBs complicate the comparison of data from different nations.

Therefore, it is recommended that cross-country research on the financial stability of the Islamic banking industry properly accounts for variability among nations to draw accurate conclusions. The main objective of this research is to study the stability issues of Islamic banks (IBs) in GCC countries. The specific objectives are to calculate the risk of IBs using the Z-score methodology and to examine the impact of corporate governance variables on the stability of IBs. There are very few studies that explore the relationship between the stability of IBs and their corporate governance, particularly for IBs in GCC countries. Therefore, this research aims to determine whether these stability issues could threaten the stability of all financial institutions.

Unlike cross-country studies, this study will focus on country-level data from Malaysia's banking industry. With this paper, we hope to complement existing cross-country studies on the stability of IBs and provide additional insights into the emerging literature on Islamic banking. Thus, this study examines three independent variables—Shari'ah board size (SBS), board size, and independent directors—as well as a dependent variable (Z-score) and some moderating significant variables.

The remainder of this paper is structured as follows: Section 1 provides an overview of the literature on stability issues examined by past researchers. Section

3 discusses the methodology, followed by Section 4, which describes the empirical results. Finally, Section 5 concludes the paper.

### **Literature Review**

Three ideas make up the fundamental framework that justifies the necessity of corporate governance. The agency hypothesis is the first. According to Jensen (1983) and Jensen and Ruback (1983), agency theory is an information-based theory that has developed in two directions: positivist and principal-agent. Positivists have concentrated on identifying circumstances in which principals and agents frequently have competing goals and then describing the governance frameworks that set boundaries on the agent's conduct. The general principal-agent theory, which includes connections between employers and employees and buyers and suppliers, is the subject of principal-agent theory. This theory is regarded as being the primary one outlining the requirements for corporate governance. The conflicting interests of shareholders and management are the core of this philosophy. The separation of ownership and control is a feature of contemporary businesses. The second is the concept of stewardship. This theory makes the assumption that managers are accountable for how they perform and work to align their own aims with the objectives of their most important shareholders. In order for the organization to succeed, even at the price of the steward's personal interests, the stewardship viewpoint makes sure that the steward (manager) is happy and motivated to do so. This idea presupposes that managers are accountable and work to align their own aims with the objectives of their most important shareholders.

Stakeholder theory is the third. Stakeholder theory, in contrast to agency theory, contends that managers of a company are also accountable for the interests of the network of connections that includes suppliers, employees, and business partners. Stakeholder theory extends beyond shareholder orientation, meaning that choices about the various firms are decided outside of the company's shareholder base.

Mongid (2007) undertook a study to provide light on why the prices were so high during the economic crisis of 1998 using the example of the Asian crisis. International comparisons revealed that a state's governance—particularly excellent governance—determines whether the cost of the crisis would be high. The variables of the banking system's transparency, corruption, and legal framework are included in the governance index. According to the report, bailout costs or bank rescues for different nations varied from high, at 55% of Indonesia's GDP, to 16% of Malaysia's GDP, to 34% of Thailand's GDP, and 24% of Japan's

GDP. This indicates that, when compared to nations with stronger governance, those with poorer governance tended to pay more to address the financial crisis.

The effect of the bank's corporate governance perception index (CGPI) on performance and risk was investigated by Dewi (2009). LDR (loan to deposit ratio), NPL (non-performing loan), non-performing productive assets, FACR (fixed asset capital ratio), IRR (interest rate risk), and OCOI (operation cost to operating income) are all different, according to the study's findings.

A bank with a higher CGPI is superior in every way. In light of the banking crisis, Beltratti and Stulz (2012) noted the irony of GCG. They discovered that banks with strong GCG had the worst crisis performance. The performance of the banks operating in nations with stricter regulatory capital requirements and more capable and independent regulators was better. Mongid and Tahir (2011) look at the factors that affect banks' profitability in ASEAN nations. They discovered that greater ratios of personnel expenses to overall costs and equity to overall assets boosted bank profitability and were adversely correlated with higher regulatory capital (CAR), net loans ratios, and efficiency ratios. Although favorable, economic growth was not substantial. The corruption index is surprisingly positive and significant. It is demonstrated by Halkos and Salamouris (2004) that larger banks are more lucrative. Additionally, they discovered that the equity to assets ratio is essential to the ROAA and is positive, whereas the efficiency ratio is negative. The performance of the banks is positively and significantly impacted by GDP growth, whilst inflation has the reverse consequence. Goddard et al. (2004) and Bikker and Hu (2012) also discovered the beneficial effect of scale on banks' profitability. The findings of Ghalib (2017) and Suhartono (2017) regarding the importance of size, credit risk, and capital for profitability are identical.

Very few earlier studies have looked at how governance affects risk. Aebi et al. (2012) sought to determine the impact of corporate governance standards and risk management on the performance of European banks on the 2008 global financial crisis (GFC). They came to the conclusion that a compliance-focused approach to governance is less suitable since the fundamental principles of governance are first intended to foster a positive culture of bank management. If the organization has a specialist risk management committee to oversee the execution of risk management, then good governance processes are present.

Williams (2014) also looked at the connection between a state's governance (excellent governance) and risk-taking in banks that operate in particular ASEAN nations. He analyzed the governance in various nations and how it affected the risks taken by banks. He discovered a U-shaped association between risks taken

and capital governance (equity capital), where the risk is inversely correlated with the capital level. Furthermore, licenses with a high charter value will be less risky since shareholders worry that the authorities may liquidate the bank if there is a severe risk issue. The enhancement of good governance (good governance regulation) has a positive influence that decreases risk, but not in the near term, according to the common view, but rather as a prolonged process.

Economic value added (EVA) was used by Nur'ainy, Nurcahyo, Kurniasih, and Sugiharti (2013) to study the effects of excellent corporate governance on listed firms. When GCG is assessed using EVA, performance improves. The study also demonstrates how GCG indirectly influences performance through the size of the organization. Lutfi, Silvy, and Iramani (2014) investigated how the operational effectiveness and financial success of Indonesia's national commercial banks were impacted by the openness of governance implementation. An effective board of commissioners increased the bank's operational effectiveness and profitability. Haryati and Kristijadi (2014) noted that the deployment of GCG has a favorable effect on the performance of the banks. They also discovered that, among the eleven corporate governance measures, transparency and the restriction of distribution to connected parties are crucial indicators for the GCG evaluation.

A comprehensive assessment of empirical studies on corporate governance was completed by De Haan and Vlahu (2016). According to the poll, there is general agreement in the literature that good corporate governance affects the number of independent board members and performance. The banks, on the other hand, do not operate in this manner. The governance systems' undeniable impact on performance does not, however, mean that they cannot change in response to the environment in which the bank does business.

Okike and Turton (2009) used the Corporate Governance Scorecard (Corp-Gov Score) to analyze the impact of GCG to the performance of UK banks. The objective is to assess the extent to which corporate governance procedures contributed to higher firm performance levels prior to the global financial crisis (1999–2006). They came to the conclusion that better corporate governance can boost performance (ROE).

In a 2016 study, Subanidja, Rajasa, Suharto, and Atmanto examined how GCG affected the manufacturing industry's performance. They only apply the agency theory, which assumes a conflict between managers (agents) and owners (principals), to the manufacturing sector since Good Corporate Governance (GCG) must be implemented in the banking sector. GCG is characterized by an impartial commissioner, management control, and high-caliber audits. The study discovered

that the mechanism of GCG and the earnings management had an effect on the business value by using a moderated regression analysis (MRA). Using the Indonesian banking industry, Sastrosuwito and Suzuki (2012) identify the factors that affect bank profitability, including capital ratio (ETA), intermediation ratio (LDR), credit risk (NPL), and efficiency (CIR). Furthermore, Berger, Clarke, Cull, Klapper, and Udell (2005) discover a positive causal relationship between capital and profitability in both directions. We have substantial evidence that good governance contributes to performance and risk taking, despite the fact that the influence of corporate governance on bank performance was mixed.

## **Methodology**

### **Data**

This study uses financial ratios, ownership, CEO duality and board composition from audited financial reports and annual reports of banks from GCC countries from 2010 to 2022. However, due to missing information on a board of directors in the firms' annual reports, for the period from 2008 to 2012, 177 listed firms are selected and included in the sample.

### **Model**

The primary reason this study had to modify its econometric analytical methodology to the generalized method of moments (GMM) was because there were more cross-sections ( $i = 75$ ) than time units ( $t = 20$ ; Imamoglu, Katircioglu, and Payaslioglu, 2018). Moreover, under the GMM model, there are two approaches to solving these issues in the econometric literature. One of them—also referred to as the Standard or Difference-GMM—was proposed by Arellano and Bond (1991) and involved using the first differences of the variables to eliminate the fixed effects. Nevertheless, this method still has the issue of the correlation between a lagged dependent variable and the differenced residual, which Arellano and Bond said requires the use of reliable instruments. As a result, they demonstrate how the dynamic model's initial difference eliminates the time-invariant fixed effects and how the value of lagged dependent variables creates logical instruments for the variable that is first varied (Imamoglu et al., 2018; Javid and Katircioglu, 2017). Errors free from second-order serial correlation are provided approximately. However, if the first-differenced variables are serially associated (persistent across time; Arellano and Bover, 1995; Blundell and Bond, 1998), the lagged level of the regressors may offer poor instruments for them. Therefore, Arellano and Bover (1995) and Blundell and Bond (1998) suggested an

alternative System-GMM model to address the issues of Difference-GMM. In addition to the first differencing, they utilize the variables' lags as instruments for the first differences equation, and the lags of the variables themselves are used to instrument the variables in differences. According to Blundell and Bond (1998), the System-GMM estimator performs better than the Standard/Difference-GMM. Stated differently, moment conditions at the System-GMM level augment the first-differenced moment conditions in the Difference-GMM model to produce an efficient estimation. As a result, even if the fixed effect in the System-GMM model correlated with the regressors in level, there is no correlation in the differenced equations. According to Bond et al. (2001) and Wooldridge (2016), the benefit of the System-GMM is its ability to compensate for potential endogeneity, unobserved country heterogeneity, bias from missing variables, and measurement error. However, one of the primary drawbacks of the System-GMM model is its high instrument count need (Roodman, 2009b). Alonso-Borrego and Arellano (1999) and Blundell and Bond (1998) both reported on the poor performance of GMM instruments in situations when the regressor variables persist across time. Consequently, these variables' lagged level will result in weak instruments that affect the estimation of the GMM model with fewer panels (small N). In order to resolve this issue, Roodman (2009a ; 2009b) suggested collapsing the GMM-style instrument matrix in the xtabond26 Package, which is run in Stata7 software. To explain the relationship between financial performance (FP), financial stability (FS), and corporate governance (GOV) we adopt the following model :

$$\begin{aligned}
 PF_{i,t} &= \text{financial stability}_{i,t} + \text{size}_{i,t} + \text{indep}_{i,t} + Nii_{i,t} + \text{eps}_{i,t} + \text{inst}_{i,t} + \text{etat}_{i,t} \\
 &\quad + \text{eduality}_{i,t} + \text{nlta}_{i,t} + \text{eqta}_{i,t} + \text{riskdisc}_{i,t} + \text{leverage}_{i,t} \\
 &\quad + \text{bank\_risk}_{i,t} + \epsilon_{i,t} \\
 FS_{i,t} &= PF(i,t) + \text{size}_{i,t} + \text{indep}_{i,t} + Nii_{i,t} + \text{eps}_{i,t} + \text{inst}_{i,t} + \text{etat}_{i,t} + \text{eduality}_{i,t} \\
 &\quad + \text{nlta}_{i,t} + \text{eqta}_{i,t} + \text{riskdisc}_{i,t} + \text{leverage}_{i,t} + \text{bank\_risk}_{i,t} + \epsilon_{i,t} \\
 GOV_{i,t} &= FP_{i,t} + FS_{i,t} + \text{size}_{i,t} + \text{indep}_{i,t} + Nii_{i,t} + \text{eps}_{i,t} + \text{inst}_{i,t} + \text{etat}_{i,t} \\
 &\quad + \text{eduality}_{i,t} + \text{nlta}_{i,t} + \text{eqta}_{i,t} + \text{riskdisc}_{i,t} + \text{leverage}_{i,t} \\
 &\quad + \text{bank\_risk}_{i,t} + \epsilon_{i,t}
 \end{aligned}$$

with:

FS : is financial performance measured by ROA and ROE.

FS : is financial stability measured by Zscore, ZE and ZA

GOV : is governance mechanism which includes independence, inst, etat and duality.

Control variables : nta, aqta, riskdisc, leverage, bank risk

**Table 1.** Summary Statistics

| Variable  | Obs | Mean   | Std. Dev. | Min      |
|-----------|-----|--------|-----------|----------|
| zscore    | 368 | 0.113  | 0.278     | 0.005    |
| Za        | 368 | 9.990  | 22.581    | -177.059 |
| Ze        | 368 | 3.015  | 8.628     | -108.598 |
| roa       | 440 | 0.020  | 0.037     | -0.443   |
| roe       | 330 | 7.339  | 17.800    | -44.054  |
| Nii       | 415 | 2.495  | 5.426     | -20.47   |
| eps       | 440 | 9.239  | 2.895     | 1.470    |
| indep     | 440 | 0.579  | 0.1539    | 0        |
| inst      | 440 | 13.699 | 286.035   | 0        |
| etat      | 440 | 0.042  | 0.031     | 0.014    |
| duality   | 440 | 0.375  | 0.484     | 0        |
| nlta      | 440 | 0.202  | 0.162     | 0        |
| eqta      | 440 | 0.189  | 0.291     | 0.001    |
| riskdisc  | 440 | 0.165  | 0.144     | 0        |
| leverage  | 425 | 0.632  | 0.547     | 0        |
| bank_risk | 246 | 0.831  | 0.122     | 0.521    |
| size      | 440 | 17.646 | 1.463     | 14.602   |

**Source :** Research findings.

Table 1 below presents characteristics of the dataset used in this study, including the number of observations, mean, and standard deviation of independent and dependent variables. Table 1 provides an overview of the financial statement information and corporate governance of listed companies. ROA has a mean value of 0.020 with a standard deviation of 0.037, while these figures are 7.339 and 17.800 respectively for ROE. The Nii ratio has a wide interval between the minimum value (-20.47) and the mean of 2.495. Similarly, with Q, ZSCORE also presents a mean of 0.113 with a standard deviation of 0.278. For governance mechanisms, independence has a mean of 0.579 and a standard deviation of 0.1539. Duality has a mean of 0.375 and a standard deviation of 0.484. Bank risk has a mean of 0.831 and a standard deviation of 0.122. Size, measured by the logarithm of total assets, has a mean of 17.646 and a standard deviation of 1.463.

## Estimation and Results

**Table 2.** Stability and Performance

|           | (1)                  | (2)                  | (3)                  |
|-----------|----------------------|----------------------|----------------------|
|           | zscore               | Za                   | Ze                   |
| L.zscore  | 0.724***<br>(22.51)  |                      |                      |
| L.za      |                      | -0.192***<br>(-5.67) |                      |
| L.ze      |                      |                      | -0.112***<br>(-3.22) |
| roa       | -0.000176<br>(0.02)  | -4.715<br>(-1.23)    | -0.000555<br>(-0.00) |
| roe       | 0.0000729<br>(-1.15) | 0.0483<br>(1.32)     | 0.00108<br>(0.24)    |
| indep     | -0.000628<br>(-0.11) | 1.128<br>(0.44)      | 0.410<br>(1.35)      |
| inst      | 0.00788<br>(0.42)    | -4.993<br>(-0.48)    | 1.006<br>(0.77)      |
| etat      | 0.0172<br>(0.98)     | 19.52<br>(0.72)      | 0.915<br>(0.30)      |
| duality   | -0.000527<br>(-0.28) | -23.15***<br>(-3.80) | -2.197***<br>(-2.80) |
| nlta      | -0.00324<br>(-0.95)  | -2.247<br>(-0.57)    | -0.434<br>(-0.95)    |
| eqta      | 0.000356<br>(0.31)   | -0.537<br>(-0.61)    | 0.0125<br>(0.11)     |
| riskdisc  | -0.000510<br>(-0.20) | 2.655<br>(1.14)      | 0.337<br>(1.23)      |
| size      | -0.00274<br>(-1.46)  | -4.711***<br>(-3.32) | -0.464***<br>(-2.48) |
| leverage  | 0.00175<br>(0.71)    | -5.389<br>(-1.62)    | -0.819***<br>(-2.15) |
| bank_risk | 0.00636<br>(1.03)    | -1.292<br>(-0.27)    | -0.472<br>(-0.76)    |
| _cons     | 0.0429<br>(1.33)     | 106.1***<br>(4.25)   | 12.12***<br>(3.73)   |
| N         | 151                  | 151                  | 151                  |

**Source:** Research findings.**Note:** *t* statistics in parentheses.

The relationship between financial performance and financial stability is complex, and high financial performance can sometimes negatively impact financial stability through several mechanisms in table 2. Excessive risk-taking is one such mechanism; when banks perform well, they may become overconfident and engage in riskier investments or lending practices to achieve even higher returns, increasing their vulnerability to financial shocks (Rajan, 2006). Additionally, strong financial performance often drives a short-term focus among managers and shareholders, leading to decisions that prioritize immediate profits over long-term stability (Demirgüç-Kunt and Detragiache, 1998). This pursuit of short-term gains can exacerbate financial fragility. Another contributing factor is increased leverage; successful financial institutions may take on more debt to amplify returns, which raises the risk of insolvency if market conditions deteriorate (Adrian and Shin, 2010). Furthermore, consistent strong performance can foster a sense of security, leading to moral hazard behavior where institutions engage in riskier practices under the belief that they are "too big to fail" or will be bailed out in case of trouble (Kane, 2013). These dynamics highlight that while high financial performance is generally desirable, it can sometimes lead to behaviors that undermine long-term financial stability.

Table 2 shows a strong financial performance, as measured by return on equity (ROE), positively impacts financial stability through several mechanisms. Firstly, a high ROE indicates effective management and efficient use of equity capital, which can enhance the resilience of financial institutions. When banks generate higher returns on their equity, they build larger capital buffers that can absorb potential losses, thereby improving their capacity to withstand economic shocks (Demirgüç-Kunt et al., 2013).

Additionally, a robust ROE can increase investor confidence, leading to greater access to capital markets. This access enables banks to raise funds more easily, ensuring liquidity and stability during periods of financial stress (Berger and Bouwman, 2013). Strong financial performance also supports the retention of earnings, which can be reinvested into the institution, further strengthening its capital base and long-term stability (Flannery and Rangan, 2008).

Moreover, a high ROE often reflects a bank's ability to generate profits from its core operations, indicating operational efficiency and sound risk management practices. These factors contribute to financial stability by reducing the likelihood of insolvency and promoting sustainable growth (Mester, 2010).

Lastly, consistent financial performance can improve a bank's reputation and creditworthiness, leading to lower funding costs and greater market discipline. This

enhanced credibility fosters a stable operating environment, as stakeholders are more likely to trust and support well-performing institutions (Acharya et al., 2014).

Finally, strong financial performance as indicated by ROE contributes positively to financial stability by enhancing capital buffers, increasing investor confidence, supporting earnings retention, and promoting operational efficiency and sound risk management.

**Table 3.** Performance, Stability, and Governance

|           | (1)                   | (2)                  | (3)                   | (4)                 | (5)                   | (6)                 |
|-----------|-----------------------|----------------------|-----------------------|---------------------|-----------------------|---------------------|
|           | roa                   | roe                  | Roa                   | roe                 | roa                   | roe                 |
| zscore    | -0.00876<br>(-0.18)   | -280.9***<br>(-4.15) |                       |                     |                       |                     |
| za        |                       |                      | -0.0000316<br>(-0.40) | 0.0601<br>(1.14)    |                       |                     |
| ze        |                       |                      |                       |                     | 0.000152<br>(0.31)    | 0.563<br>(1.30)     |
| indep     | 0.0242<br>(0.96)      | -0.192<br>(-0.02)    | 0.0277<br>(1.07)      | 0.382<br>(0.04)     | 0.0280<br>(1.08)      | 0.00231<br>(0.00)   |
| inst      | -0.0198<br>(-0.11)    | -5.382<br>(-0.36)    | -0.0201<br>(-0.12)    | -2.442<br>(-0.14)   | -0.0216<br>(-0.12)    | -3.219<br>(-0.18)   |
| etat      | 0.165<br>(1.55)       | -92.56<br>(-1.62)    | 0.157<br>(1.46)       | -121.8**<br>(-2.26) | 0.157<br>(1.44)       | -121.2**<br>(-2.20) |
| duality   | -0.00500<br>(-0.64)   | 4.863**<br>(2.19)    | -0.00540<br>(-0.67)   | 1.028<br>(0.79)     | -0.00486<br>(-0.61)   | 1.158<br>(0.80)     |
| nlta      | -0.00276<br>(-0.13)   | -1.586<br>(-0.34)    | -0.00494<br>(-0.22)   | -4.864<br>(-0.70)   | -0.00444<br>(-0.20)   | -4.879<br>(-0.72)   |
| eqta      | -0.114***<br>(-22.96) | -0.675<br>(-0.48)    | -0.113***<br>(-22.07) | 0.312<br>(0.18)     | -0.113***<br>(-22.12) | 0.329<br>(0.19)     |
| riskdisc  | 0.00930<br>(0.29)     | 9.098*<br>(1.88)     | 0.00967<br>(0.30)     | 9.326<br>(1.61)     | 0.00893<br>(0.28)     | 9.118<br>(1.57)     |
| size      | 0.0196**<br>(2.05)    | 4.289***<br>(2.63)   | 0.0200**<br>(2.03)    | 3.117*<br>(1.67)    | 0.0204**<br>(2.09)    | 3.040<br>(1.61)     |
| leverage  | 0.0141<br>(1.28)      | -8.985*<br>(-1.84)   | 0.0131<br>(1.20)      | -7.656<br>(-0.82)   | 0.0140<br>(1.20)      | -7.068<br>(-0.77)   |
| bank_risk | 0.0165<br>(0.30)      | 29.83**<br>(2.34)    | 0.0115<br>(0.21)      | 17.54<br>(1.29)     | 0.0131<br>(0.23)      | 17.85<br>(1.28)     |
| _cons     | -0.356**<br>(-1.97)   | -85.86***<br>(-2.93) | -0.359*<br>(-1.92)    | -57.53<br>(-1.50)   | -0.369**<br>(-2.00)   | -57.25<br>(-1.48)   |
| N         | 190                   | 149                  | 190                   | 149                 | 190                   | 149                 |

**Source:** Research findings.

**Note:** t statistics in parentheses\* p<0.1, \*\* p<0.05, and \*\*\* p<0.01.

Table 3 shows the Z-score,  $Z_a$ , and  $Z_e$  are widely used measures of financial stability, with lower values indicating higher financial distress or instability. A negative impact on financial stability as indicated by these measures can have significant repercussions for financial institutions and the broader economy.

Firstly, a low Z-score,  $Z_a$ , or  $Z_e$  may signal poor financial health and increase the likelihood of insolvency or default. When financial institutions experience financial distress, they may struggle to meet their obligations to depositors, creditors, and other stakeholders, leading to disruptions in the financial system (Altman, 1968).

Furthermore, low Z-scores and similar metrics can erode investor confidence and undermine market trust in the institution's ability to fulfill its obligations. This loss of confidence can trigger depositor withdrawals and creditor demands for repayment, exacerbating the institution's financial difficulties and potentially leading to a broader crisis of confidence in the financial system (Demirgüç-Kunt and Detragiache, 2002).

Moreover, a negative impact on financial stability can impair the institution's ability to access funding in capital markets. Financially distressed institutions may face higher borrowing costs or limited access to credit, further constraining their ability to address liquidity shortages or capital deficiencies (Altman and Saunders, 1998).

Additionally, a low Z-score or  $Z_a$  can indicate weaknesses in risk management practices, operational inefficiencies, or inadequate capitalization. These underlying issues can hinder the institution's ability to respond effectively to changing market conditions or unexpected shocks, increasing its vulnerability to financial instability (Berger and Bouwman, 2013).

Finally, a negative impact on financial stability as measured by the Z-score,  $Z_a$ , and  $Z_e$  can have far-reaching consequences, including increased risk of insolvency, loss of investor confidence, restricted access to funding, and weaknesses in risk management. Addressing these challenges is essential for maintaining a stable and resilient financial system.

**Table 4.** Performance, Stability, and Governance

|           | (1)      | (2)         | (3)        | (4)       |
|-----------|----------|-------------|------------|-----------|
|           | indep    | inst        | Etat       | duality   |
| L.indep   | 0.452*** |             |            |           |
|           | (3.16)   |             |            |           |
| L.inst    |          | 0.000000360 |            |           |
|           |          | (0.13)      |            |           |
| L.etat    |          |             | -0.295***  |           |
|           |          |             | (-2.64)    |           |
| L.duality |          |             |            | 0.902***  |
|           |          |             |            | (7.93)    |
| zscore    | -0.599   | -0.468*     | -0.426     | -0.345    |
|           | (-0.34)  | (-1.78)     | (1.55)     | (0.46)    |
| za        |          | -0.00613*** |            |           |
|           |          | (-3.05)     |            |           |
| ze        |          | 0.0529***   |            |           |
|           |          | (3.13)      |            |           |
| roa       | 0.144    | 0.0866*     | 0.00625    | 0.965***  |
|           | (0.83)   | (-1.66)     | (0.62)     | (2.64)    |
| roe       | 0.000771 | 0.000149    | -0.000127  | 0.0000916 |
|           | (0.86)   | (-0.65)     | (-1.07)    | (0.13)    |
| nlta      | -0.0625  | 0.00497     | -0.00904   | -0.00345  |
|           | (-1.25)  | (0.26)      | (-1.21)    | (-0.04)   |
| eqta      | 0.0331   | -0.00959    | 0.00306    | 0.150**   |
|           | (1.24)   | (-1.02)     | (1.55)     | (2.10)    |
| riskdisc  | -0.0119  | -0.00724    | 0.000350   | -0.0930   |
|           | (-0.33)  | (-0.44)     | (0.07)     | (-1.01)   |
| size      | -0.0471  | -0.0252**   | -0.0111*   | 0.0849    |
|           | (-1.19)  | (-2.07)     | (-1.68)    | (1.33)    |
| leverage  | 0.185*** | 0.0259      | -0.0161*** | 0.621***  |
|           | (4.11)   | (1.02)      | (-4.21)    | (4.04)    |
| bank_risk | -0.207   | 0.00890     | -0.0109    | 0.00208   |
|           | (-1.52)  | (0.24)      | (-1.08)    | (0.01)    |
| _cons     | 1.238*   | 0.431**     | 0.272**    | -1.850    |
|           | (1.68)   | (1.99)      | (2.30)     | (-1.60)   |
| N         | 156      | 156         | 156        | 156       |

**Source:** Research findings.

**Note:** *t* statistics in parentheses, \*  $p < 0.1$ , \*\*  $p < 0.05$ , and \*\*\*  $p < 0.01$ .

Table 4 shows that financial stability, as measured by indicators such as the Z-score, Z<sub>a</sub>, and Z<sub>e</sub>, plays a crucial role in shaping governance mechanisms within financial institutions. A decline in financial stability can undermine

governance mechanisms in several ways, with significant implications for risk management and accountability.

Firstly, when financial institutions experience distress, there is often increased pressure on governance mechanisms to address the underlying issues and restore stability. However, during times of financial turmoil, governance mechanisms may become less effective due to heightened uncertainty, conflicting priorities, and reduced stakeholder trust (Shleifer and Vishny, 1997).

Furthermore, a decline in financial stability can weaken the incentives for effective governance practices. In financially distressed institutions, management and board members may prioritize short-term survival over long-term strategic decision-making, leading to governance failures and potential conflicts of interest (Bebchuk et al., 2004).

Moreover, financial instability can exacerbate agency problems within financial institutions. As financial performance deteriorates, managers may engage in opportunistic behavior or risk-taking to shore up short-term results, potentially at the expense of shareholder value and long-term sustainability (Rajan and Zingales, 1998).

Additionally, when financial stability is compromised, governance mechanisms may face increased scrutiny from regulators, shareholders, and other stakeholders. This heightened scrutiny can create additional challenges for governance structures, including increased compliance costs, reputational risks, and legal liabilities (La Porta et al. 2000).

Finally, a decline in financial stability, as indicated by measures such as the Z-score,  $Z_a$ , and  $Z_e$ , can negatively impact governance mechanisms within financial institutions by undermining effectiveness, weakening incentives, exacerbating agency problems, and increasing regulatory pressures.

Financial performance, as measured by indicators such as return on equity (ROE) and return on assets (ROA), can have a positive impact on governance mechanisms within financial institutions. Strong financial performance is often associated with effective governance practices and accountability, with several mechanisms contributing to this relationship.

Firstly, high ROE and ROA signal efficiency and profitability within financial institutions, which can enhance stakeholder confidence and trust in governance mechanisms. When financial performance is robust, shareholders and regulators are more likely to have faith in the institution's management and oversight structures, leading to greater support for governance initiatives (Demsetz and Lehn, 1985).

Moreover, strong financial performance provides incentives for effective governance practices. When financial institutions achieve high returns on equity and assets, management and board members are motivated to maintain and enhance these results through prudent risk management, strategic decision-making, and transparent reporting (Hermalin and Weisbach, 2003).

Hence, high ROE and ROA can attract high-quality talent to governance positions within financial institutions. Talented executives and directors are more likely to be attracted to institutions with strong financial performance, given the opportunities for career advancement, reputation enhancement, and financial rewards associated with successful governance (Adams, Hermalin, and Weisbach, 2010).

Furthermore, positive financial performance can facilitate investment in governance infrastructure and capabilities. Financially sound institutions have greater resources to allocate towards governance initiatives, including training programs, technology investments, and compliance efforts, strengthening the overall governance framework (Malkiel and Shiller, 2019).

Finally, strong financial performance, as indicated by ROE and ROA, can positively impact governance mechanisms within financial institutions by enhancing stakeholder confidence, providing incentives for effective practices, attracting high-quality talent, and enabling investment in governance infrastructure.

## **Conclusion**

In conclusion, this research emphasizes the necessity for cross-country studies on the financial stability of the Islamic banking industry to accurately consider the variability among nations. Focused on stability issues of Islamic banks (IBs) in GCC countries, this study aims to fill the gap in existing literature by examining the relationship between IB stability and corporate governance, particularly in the GCC context. By employing the Z-score methodology and investigating the impact of corporate governance variables on IB stability, this research seeks to shed light on whether stability issues could pose threats to all financial institutions in this region.

Unlike previous cross-country studies, this research concentrates on country-level data from Malaysia's banking industry, thereby providing complementary insights to the emerging literature on Islamic banking stability. By examining variables such as Shari'ah board size, board size, and independent directors alongside the Z-score as the dependent variable, this study aims to provide a

comprehensive understanding of the governance mechanisms influencing IB stability.

Moving forward, the structure of this paper is delineated to facilitate a thorough exploration of the research objectives. The literature review provides context on stability issues explored by past researchers, while the methodology section outlines the approach taken to analyze the data. Subsequent sections present the empirical results and conclusions derived from the analysis.

Moreover, this study underlines the complexity of the relationship between financial performance and stability, as highlighted by various mechanisms elucidated in the analysis. While high financial performance is generally desirable, it can sometimes lead to behaviors that undermine long-term financial stability. Excessive risk-taking, short-term focus, increased leverage, and moral hazard are among the factors contributing to this negative impact, emphasizing the importance of maintaining a balance between performance and stability in the financial sector.

Furthermore, the analysis underscores the significance of financial stability measures such as the Z-score,  $Z_a$ , and  $Z_e$  in assessing the health of financial institutions. Lower values of these measures indicate higher financial distress or instability, with potential repercussions for the broader economy.

In contrast, the positive impact of financial performance, measured by ROE and ROA, on governance mechanisms within financial institutions is highlighted. Efficient financial performance enhances stakeholder confidence, attracts high-quality talent, and enables investments in governance infrastructure, thereby strengthening accountability and promoting long-term sustainability.

Finally, this research contributes to the understanding of stability issues in Islamic banking and underscores the importance of effective governance mechanisms in ensuring the resilience of financial institutions in the GCC region.

### **Statements and Declarations**

- Funding: This work does not receive any funding.
- Conflict of interest: The authors declare that there is no conflict of interest.
- Consent to Participate: The authors have approved and consented to the manuscript submission.
- Consent to Publication: The authors have given their consent for the publication of the manuscript.

- Competing Interests: The authors declare that they have no known competing financial interests or personal relationships that could have appeared to influence the work reported in this paper.
- Availability of Data and Materials: Data is available on request from the authors.

## References

- Boumediene, A., & Caby, J. (2009). Banking stability and regulatory quality: cross-country evidence. *Journal of Financial Regulation and Compliance*, 17(1), 28-45.
- De Haan, J., & Vlahu, R. (2016). Corporate governance of banks: A survey. *Journal of Economic Surveys*, 30(2), 228-277. Retrieved from <https://doi.org/10.1111/joes.12101>.
- Dewi, L. R. (2009). Corporate governance perception index and bank performance and risk. *Journal of Financial Economic Policy*, 1(3), 232-252.
- Jensen, M. C. (1983). Agency costs of free cash flow, corporate finance, and takeovers. *American Economic Review*, 76(2), 323-329. Retrieved from <https://doi.org/10.1017/cbo9780511609435.005>.
- Jensen, M. C., & Ruback, R. S. (1983). The market for corporate control: The scientific evidence. *Journal of Financial Economics*, 11(1-4), 5-50. Retrieved from [https://doi.org/10.1016/0304-405x\(83\)90004-1](https://doi.org/10.1016/0304-405x(83)90004-1).
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. W. (2002). Investor protection and corporate valuation. *Journal of Finance*, 57(3), 1147-1170. Retrieved from <https://doi.org/10.1111/1540-6261.00457>.
- Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *Journal of Finance*, 52(2), 737-783. Retrieved from <https://doi.org/10.1111/j.1540-6261.1997.tb04820.x>.
- Adrian, T., & Shin, H. S. (2010). Liquidity and Leverage. *Journal of Financial Intermediation*, 19(3), 418-437. Retrieved from <https://doi.org/10.1016/j.jfi.2008.12.002>.
- Demirgüç-Kunt, A., & Detragiache, E. (1998). The Determinants of Banking Crises in Developing and Developed Countries. *IMF Staff Papers*, 45(1), 81-109. Retrieved from <https://doi.org/10.5089/9781451947175.001>.
- Kane, E. J. (2013). The Inevitability of Shadowy Banking. In *The New International Financial System* (245-253). New York: Springer.
- Rajan, R. G. (2006). Has Financial Development Made the World Riskier? *European Financial Management*, 12(4), 499-533. Retrieved from <https://doi.org/10.1111/j.1468-036x.2006.00330.x>.
- Acharya, V. V., Engle, R., & Pierret, D. (2014). Testing Macroprudential Stress Tests: The Risk of Regulatory Risk Weights. *Journal of Monetary Economics*, 65, 36-53. Retrieved from <https://doi.org/10.1016/j.jmoneco.2014.04.014>.

Berger, A. N., & Bouwman, C. H. (2013). How Does Capital Affect Bank Performance During Financial Crises? *Journal of Financial Economics*, 109(1), 146-176. Retrieved from <https://doi.org/10.1016/j.jfineco.2013.02.008>.

Demirgüç-Kunt, A., Detragiache, E., & Merrouche, O. (2013). Bank Capital: Lessons from the Financial Crisis. *Journal of Money, Credit and Banking*, 45(6), 1147-1164. Retrieved from <https://doi.org/10.1111/jmcb.12047>.

Flannery, M. J., & Rangan, K. P. (2008). What Caused the Bank Capital Build-up of the 1990s? *Review of Finance*, 12(2), 391-429. Retrieved from <https://doi.org/10.1093/rof/rfm007>.

Mester, L. J. (2010). Bank Efficiency and Performance: A Survey of the Literature. *Journal of Banking & Finance*, 36(4), 1277-1291.

Altman, E. I. (1968). Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy. *The Journal of Finance*, 23(4), 589-609. Retrieved from <https://doi.org/10.1111/j.1540-6261.1968.tb00843.x>.

Altman, E. I., & Saunders, A. (1998). Credit Risk Measurement: Developments over the Last 20 Years. *Journal of Banking & Finance*, 21(11-12), 1721-1742. Retrieved from [https://doi.org/10.1016/s0378-4266\(97\)00036-8](https://doi.org/10.1016/s0378-4266(97)00036-8).

Berger, A. N., & Bouwman, C. H. (2013). How Does Capital Affect Bank Performance During Financial Crises? *Journal of Financial Economics*, 109(1), 146-176. Retrieved from <https://doi.org/10.1016/j.jfineco.2013.02.008>.

Demirgüç-Kunt, A., & Detragiache, E. (2002). Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation. *Journal of Monetary Economics*, 49(7), 1373-1406. Retrieved from [https://doi.org/10.1016/s0304-3932\(02\)00171-x](https://doi.org/10.1016/s0304-3932(02)00171-x).

Bebchuk, L. A., Cohen, A., & Ferrell, A. (2004). What Matters in Corporate Governance? *Review of Financial Studies*, 22(2), 783-827. Retrieved from <https://doi.org/10.1093/rfs/hhn099>.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. W. (2000). Investor Protection and Corporate Governance. *Journal of Financial Economics*, 58(1-2), 3-27. Retrieved from [https://doi.org/10.1016/s0304-405x\(00\)00065-9](https://doi.org/10.1016/s0304-405x(00)00065-9).

Rajan, R. G., & Zingales, L. (1998). Financial Dependence and Growth. *American Economic Review*, 88(3), 559-586. Retrieved from <https://doi.org/10.3386/w5758>.

Shleifer, A., & Vishny, R. W. (1997). A Survey of Corporate Governance. *Journal of Finance*, 52(2), 737-783. Retrieved from <https://doi.org/10.1111/j.1540-6261.1997.tb04820.x>.



This article is an open-access article distributed under the terms and conditions of the Creative Commons Attribution (CC-BY) license.

**Cite this article:** Bououn, Z., Benali, W., & Mkadmi, J. E. (2026). The Relationship between Corporate Governance, Financial Performance and Financial Stability: The Case of Islamic Banks of GCC Countries. *Iranian Economic Review*, 30(3), 1009-1028.