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IMPACT OF FINANCING RISK ON PROFITABILITY OF ISLAMIC BANKS

Zineb Afif [(a)] *Camélia Sehaqui* [(b)1] *Mohamed Haissoune* [(c)] *Mohamed Azeroual* [(d)]

[(a)]*Ph.D. Student, Laboratory of Economics and Management (LEG), Sultan Moulay Slimane University, Morocco; E-mail: zinebafif165@gmail.com*
[(b)]*Ph.D. Candidate, Research Laboratory in Management and Development (LRMD), Faculty of Economics and Management, Hassan First University of Settat, Morocco; E-mail: sehaquic@gmail.com*
[(c)] *Professor, Research Laboratory in Management and Development (LRMD), Faculty of Economics and Management, Hassan First University of Settat, Morocco; E-mail: mohamed.haissoune@uhp.ac.ma*
[(d)] *Professor, Laboratory of Economics and Management (LEG), Sultan Moulay Slimane University, Morocco; E-mail: azeroualmoh@gmail.com*

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ABSTRACT

Banks, as financial intermediaries, face a variety of risks that significantly affect their performance and stability. Islamic banks, like conventional banks, are particularly vulnerable to financing risk, which directly affects their profitability and, if not properly managed, can lead to severe financial distress or even bankruptcy. The purpose of this study is to investigate the relationship between financing risk and the profitability of Islamic banks operating in the MENA region. This research utilizes a panel dataset comprising 14 Islamic banks over ten years from 2013 to 2022. Profitability is measured through the return on assets (ROA), while financing risk is assessed using the nonperforming financing ratio, the financing-to-asset ratio, and the capital adequacy ratio. The study employs panel regression analysis to evaluate secondary data extracted from banks' financial reports. The results indicate that both the financing-to-asset ratio and the capital adequacy ratio have a positive impact on the return on assets, suggesting that a well-managed financing structure and robust capital adequacy contribute to enhancing bank profitability. Conversely, the findings reveal that the nonperforming financing ratio negatively impacts the return on assets, highlighting the detrimental effects of poor financing quality on overall bank performance. The significant findings of this study suggest that Islamic banks should place a greater emphasis on mitigating financing risk through maintaining a strong capital base, diversifying their portfolios, and implementing effective credit risk management practices. This approach would not only enhance profitability but also safeguard the banks against potential losses and financial crises.

INTRODUCTION

Financing risk plays a critical role in the stability and profitability of banks as it directly affects their ability to generate income while managing liquidity and solvency constraints. For Islamic banks, this risk is even more pronounced due to the requirement to comply with Sharia principles, which restrict the use of traditional hedging instruments such as interest rate futures. Unlike conventional banks, which can adjust their risk strategies using a variety of financial tools, Islamic banks must navigate within a more constrained framework, raising questions about their ability to maintain stable financial performance in volatile economic environments.

The scientific problem addressed in this research lies in understanding the factors influencing financing risk in Islamic banks and how this risk impacts their profitability. Although significant research has been conducted on financing risk in conventional banking, a notable gap remains regarding its implications for Islamic banks, particularly in emerging markets such as Morocco, where the Islamic banking sector is still in its development stage. This gap highlights the need for a focused analysis that considers the unique risk dynamics faced by Sharia-compliant institutions.

The main objective of this study is to investigate the link between financing risk and the profitability of Islamic banks, aiming to provide a comprehensive understanding of how Sharia-compliant risk management practices influence their financial outcomes. By addressing this research problem, the study aims to contribute to the existing literature by providing insights that can enhance risk management strategies in the Islamic banking sector. The findings will not only

[1]*Corresponding author: ORCID ID: 0009-0007-9838-9913*

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have theoretical implications but also offer practical recommendations for risk managers and policymakers in the field.

The article is structured as follows: The literature review section provides an overview of existing studies on financing risk and its impact on bank profitability, focusing on both conventional and Islamic banks. The methodology section outlines the data sources, variables, and econometric models used to analyze the relationship between financing risk and profitability. The results section presents the findings from the empirical analysis, while the discussion section interprets these results in the context of Islamic banking. Finally, the conclusion summarizes the main findings, discusses their implications, and suggests directions for future research.

LITERATURE REVIEW

Financing risk is a significant challenge for both conventional and Islamic banks, referring to the possibility that borrowers may fail to repay loans according to agreed terms. In Islamic banks, financing risk pertains explicitly to the borrower's inability to fulfill the obligations under the terms of an Islamic financing contract, which can result in substantial financial losses for the bank (Kabir & Lewis, 2007). Effective management of financing risk is crucial to maintaining the stability of the financial system, particularly within the unique operational context of Islamic banks.

Identifying the determinants of financing risk is key to preventing systemic crises, reducing defaults, and ensuring the ongoing smooth operation of banks. Literature suggests that the determinants of financing risk can be categorized into macroeconomic factors and bank-specific factors (Haryono et al., 2016; Castro, 2013; Aver, 2008). Macroeconomic conditions, such as economic downturns, inflation, and changes in interest rates, can weaken borrowers' creditworthiness, leading to increased default rates. Conversely, bank-specific factors are tied to the institution’s internal strategies and risk management policies. Ahmad and Bashir (2013) argue that a combination of these macroeconomic and internal factors significantly influences the level of financing risk faced by banks.

Effective financing risk management is critical to enhancing banks' stability and viability. Mismanagement or excessive exposure to this risk can lead to severe financial repercussions, including deterioration in asset quality and reduced investor confidence. In Islamic banks, financing risk management is further complicated by the nature of Sharia-compliant products, which differ fundamentally from conventional financial instruments. Sharia principles, such as the prohibition of interest (Riba) and the emphasis on profit and loss sharing, reshape how risks are managed, often necessitating alternative strategies that align with Islamic ethical standards.

Ariffin and Tafri (2014) analyzed the impact of financial risks on the profitability of Islamic banks, using data from 65 fully operational Islamic banks worldwide between 2004 and 2011. Their findings indicate a negative impact of credit risk on return on assets, specifically highlighting the interplay between credit risk and interest rate risk. However, other financial risks, such as liquidity risk, were found to have no significant effect on profitability.

Noman (2017) compared credit risk management practices between conventional and Islamic banks in Bangladesh. The study revealed that conventional banks generally have more efficient credit risk identification, assessment, monitoring, and control processes compared to Islamic banks. The findings highlighted significant differences in the understanding and management of credit risk between the two types of banks, although credit risk assessment and control practices did not differ significantly.

Al-Rdaydeh et al. (2017) demonstrated that credit risk hurts the return on assets and return on equity in both conventional and Islamic banks in Jordan. Similarly, Ali, Zulkhibri, and Kishwar (2019) found that credit risk adversely affects the performance of Islamic banks in Pakistan, based on a study of six full-fledged Islamic banks from 2002 to 2016. Explored the impact of credit risk, liquidity, and capital adequacy on the profitability of Indonesian banks, using data from 2007 to 2016. They found that credit risk and liquidity are significantly and negatively associated with bank profitability, underscoring the critical influence of risk management on financial performance.

Ahmed et al. (2022) examined the effects of financial leverage, credit risk, and liquidity risk on the performance of Islamic banks in Sudan from 2008 to 2018. The study found that credit risk and financial leverage have a significant negative impact on the financial performance of Islamic banks, while liquidity risk was largely insignificant. Compared the impact of credit risk on financial profitability between Islamic and conventional banks in the Middle East and Africa during the COVID-19 pandemic. Their analysis of 200 banks over four years indicated that nonperforming loans are negatively associated with financial performance in both types of banks. Interestingly, COVID-19 partially mediated the relationship between nonperforming loans and profitability in conventional banks but did not have the same effect on Islamic banks.

Sohail, Ali, and Raza (2022) assessed the influence of credit risk management practices on the financial performance of Pakistani banks. They found that credit risk identification and monitoring positively impact financial performance, whereas credit risk appraisal has a significant adverse effect. Credit risk control was found to have a positive but insignificant impact. Finally, compared credit risk minimization practices between Islamic and conventional banks in Yemen. Their findings demonstrated that credit risk remains the predominant risk faced by both types of banks, with conventional banks showing more effective minimization practices than Islamic banks. The reviewed literature underscores the significant impact of financing risk on the profitability and stability of banks, highlighting the unique challenges faced by Islamic banks due to their adherence to Sharia principles. While prior studies have extensively examined the effects of credit risk on bank performance, inconsistencies in findings and the evolving nature of risk management in Islamic finance suggest a need for further research. This study aims to bridge the gap by analyzing the relationship between financing risk and the profitability of Islamic banks, particularly in emerging markets where these institutions are still developing.

MATERIALS AND METHODS

Study Sample

The study sample comprises 14 Islamic banks operating in the MENA region. The study period covers 10 years, from 2013 to 2022.Financial data were recorded from the bank's annual financial reports.

Table 1. List of Islamic banks

Islamic banks	Countries
Al Baraka Bank	Egypt
Doha Bank	Qatar
Zitouna Bank	Tunisia
Boubyan Bank	Kuwait
Islamic Bank of Jordan	Jordan
Finance House	Kuwait
Attijari Al Islami	United Arab Emirates
Nizwa Bank	Oman
Sharjah Islamic Bank	United Arab Emirates
National Bank of Kuwait	Kuwait
Al Rajhi Bank	Saudi Arabia
Al Hilal Bank	United Arab Emirates
AlJazira Bank	Saudi Arabia

Source: Designed by the authors

Definitions and Measurements of Variables

- **Dependent Variable**

The dependent variable in our study is profitability. This research employs return on assets (ROA) as a measure of bank profitability. ROA determines how efficiently a bank uses its assets and makes a profit from them. A bank is more profitable and makes better use of its assets when its ROA is higher.

- **Independent variables**

The independent variables used in the study are the nonperforming financing ratio, the financing-to-asset ratio, and the capital adequacy ratio.

-The nonperforming financing ratio is one of the most important measures used in the literature to represent a bank's asset quality. A lower ratio indicates better asset quality, lower impaired financing, and therefore lower financing risk.

-The financing-to-asset ratio is the proxy used to demonstrate banks' ability to supply financing with the entire amount of assets they own. The better this indicator is, the better the credit performance and the lower the financing risk that banks can face.

-The capital adequacy ratio is an indicator of the capital used to support banks' risky assets. A bank with a high level of equity capital can absorb potential losses on its loans, thereby increasing profitability and preventing insolvency and bankruptcy.

Table 2. List of the variables

	Variable	Formula
Dependent variables	Return on assets	**Net profit/ Total assets**
Independent variables	Nonperforming financing ratio	**Nonperforming financings /total financings**
	Financing to asset ratio	**Total financings /Total assets**
	Capital adequacy ratio	**Tier 1 Capital+Tier 2 Capital /Risk-Weighted Assets**

Source: Designed by the authors

Research Methodology

The temporal and individual dimensions of our sample enabled us to use the panel data approach, which is considered a key tool in longitudinal research. Panel data also have the advantage of increasing the sample size, which in turn increasesthe number of degrees of freedom and minimizes the collinearity constraint among explanatory variables, thus improving theestimation of our results.

Presentation of the Empirical Model

The following is a specification of the empirical model that will be estimated for this study:

$$\mathbf{ROA = \beta o + \beta 1NPF + \beta 2\ TFTA + \beta 3\ CAR + e}$$

β0= constant parameter
βi (i = 1, 2,3) = independent variable coefficients e= error factor
ROA= return on assets
NPF = nonperforming financing

ratio,TFTA =financing to asset ratio,
CAR=capital adequacy ratio

Research hypotheses

The study assumptions are as follows:
H1: The return on assets of Islamic banks is negatively impacted by the nonperforming financing ratio.
H2: The return on assets of Islamic banks is positively impacted by the financing-to-asset ratio.
H3: The return on assets of Islamic banks is positively impacted by the capital adequacy ratio.

RESULTS

Descriptive Data Analysis

The research employed descriptive statistics, including mean, standard deviation, minimum, and maximum, to gain insightinto the distribution of the variable. The table below shows the descriptive analysis of all variables.

Table 3. Descriptive statistics

	ROA	NPFR	TFTA	CAR
Mean	0.013739	0.032525	0.615612	0.182080
Median	0.012550	0.020850	0.641950	0.179750
Maximum	0.069600	0.128000	0.854700	0.357900
Minimum	0.000200	0.000300	0.230900	0.072000
Std. Dev.	0.007329	0.027129	0.132622	0.038731
Skewnes s	3.327389	0.996453	0.783822	0.629916
Kurtos is	25.82315	3.527464	3.706331	6.040565
Jarque-Bera	3249.799	24.43688	16.99938	62.28521
Probability	0.000000	0.000005	0.000204	0.000000
Sum	1.896040	4.488400	84.95440	25.12710
Sum Sq. Dev.	0.007358	0.100828	2.409629	0.205512
Observations	138	138	138	138

Source: Results extracted by the authors from Eviews

According to Table 3, the average value of return on assets is 1.373%, with the other values deviating from this mean by a standard margin of 0.0073. The nonperforming financing ratio indicates an overall value of 3.252% with a standard deviation of 0.0271. Regarding the financing-to-asset ratio and the capital adequacy ratio, the results indicate averages of 61.56% and 18.20%, respectively, with standard deviations of 0.132% and 0.038%.

Correlation

Correlation demonstrates the correlation between dependent and independent variables. The study of the correlation matrix is relevant for detecting the existence or absence of a multicollinearity problem. Examination of the correlation coefficients of the variables shown in Table 4 reveals that they are below 0.7. This means that all the variables are free ofmulticollinearity.

Table 4. Correlation matrix for all variables

	ROA	NPFR	TFTA	CAR
ROA	1.000000	-0.038660	0.010713	**0.183418**
NPFR	-0.038660	1.000000	-0.411037	**-0.124282**
TFTA	0.010713	-0.411037	1.000000	**-0.096234**
CAR	**0.183418**	**-0.124282**	**-0.096234**	**1.000000**

Source: Results extracted by the authors from Eviews

Table 4 illustrates that the nonperforming financing ratio hurts the return on assets. In contrast, thefinancing-to-asset ratio and the capital adequacy ratio are positively correlated with return on assets.

Panel Regression Results

Random Effect Model

A regression model defined as a "random-effect model" uses a random sample of individuals' means from a population. The entities in this model vary randomly and are uncorrelated with the independent variables.

Table 5. Random-effect model results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.006409	0.007359	0.870905	**0.3854**
NPFR	-0.010347	0.032019	-0.323158	**0.7471**
TFTA	0.002117	0.008993	0.235439	**0.8142**
CAR	**0.034535**	**0.018399**	**1.877070**	**0.0627**

Source: Results extracted by the authors from Eviews

Table 5 reveals that the nonperforming financing ratio hurts return on assets by -0.010. However, the financing-to-asset ratio and the capital adequacy ratio have a positive correlation with the return on assets, at 0.002 and 0.034,respectively.

Fixed-Effect model

A regression model where the group means are fixed or non-random is referred to as a fixed-effects model. This method considers the particular nature of each bank in the sample.

Table 6. Fixed-effect model results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.001473	0.011930	0.123484	**0.9019**
NPFR	-0.017517	0.036830	-0.475626	**0.6352**
TFTA	0.009570	0.016489	0.580417	**0.5627**
CAR	**0.038139**	**0.020647**	**1.847179**	**0.0672**

Source: Results extracted by the authors from Eviews

In line with the previous model, the nonperforming financing ratio was found to have a negative impact of -0.017 on return on assets. However, the financing to asset ratio and the capital adequacy ratio have a positive relationship of 0.009and 0,038 on return on assets, respectively. We will now apply the Hausman test to check which model is more appropriate for our study.

Hausman Test

To determine which model is most appropriate, the Hausman test is employed. The fixed-effect model is more appropriate if $p < 0.05$,whereas the random-effect model is more suited if $p > 0.05$. Table 7 shows the results of the Hausman test.

Table 7. Hausman test results

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	**0.421359**	**3**	**0.9358**

Source: Results extracted by the authors from Eviews

The results of the Hausman test allow us to conclude that the random-effect model is the appropriate model.

Final Regression Model

Analysis of the random-effect panel data regression model showed that the return on assets is negatively impacted by the nonperforming financing ratio, with a coefficient of -0.010. This means that a one-unit rise in the nonperforming financing ratio leads to a 0.010 decrease in the profitability of banking activity, represented by ROA. This adverse effect can be explained by the fact that Islamic banks generally apply relatively high profit margins to the financing they lend. As a result of this situation, customers may default on loans. Moreover, a high default rate on financing indicates higher losses for Islamic banks and, consequently, lower profits. This confirms our first hypothesis. Thus, this result is consistentwith that of some studies, such as Al-Husainy and Jadah (2021) and Dewi and Badjra (2020), which found that the ratio of nonperforming loans negatively impacts the return on assets.

On the other side, the financing-to-asset ratio shows a positive and insignificant effect on the return on assets of Islamic banks, with a coefficient of 0.002. According to this finding, the return on assets rises by 0.002 for every unit increase in the financing to asset ratio. This result is entirely coherent, given that a bank's most important income comes from the margins it earns on the financing it grants. Thus, an increase in the financing-to-asset ratio suggests that banks can grant more financing because the amount of assets they hold to meet the demand for credit is substantial, which will ultimately lead tohigher profitability. This result supports the second hypothesis. This result aligns with other studies that have demonstrated a positive correlation between lending and bank profitability, including those by Boahene, Dasah, and Agyei (2012) and Kolapo, Ayeni, and Oke (2012).

The results also indicate a positive relationship between the capital adequacy ratio and return on assets, with a coefficient of 0.034. This suggests that a unit increase in the capital adequacy ratio would lead to a 0.034 increase in the bank's profitability. However, this result is not statistically significant. This finding supports the theoretical claim that banks with an adequate capital base can absorb financing risk losses, carry out their business activities successfully, and are more likely to generatea return. This result aligns with the findings of Akbar (2018) and Muawanah and Imronudin (2021), who discovered that the capital adequacy ratio is positively correlated with the return on assets of Islamic banks in Indonesia. Consequently, our hypothesisis validated.

Table 8. Final regression model results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.006409	0.007359	0.870905	**0.3854**
NPFR	-0.010347	0.032019	-0.323158	**0.7471**
TFTA	0.002117	0.008993	0.235439	**0.8142**
CAR	**0.034535**	**0.018399**	**1.877070**	**0.0627**

Source: Results extracted by the authors from Eviews

DISCUSSIONS

This study examines the relationship between financing risk and the profitability of Islamic banks, utilizing a panel dataset of 14 Islamic banks from the MENA region over the period 2013–2022. The study's findings are critically assessed and compared with prior research to contextualize the observed results and explore future research avenues.

The results reveal that the nonperforming financing ratio hurts return on assets (ROA), with a coefficient of -0.010 in the random-effect model. This finding supports the first hypothesis, which posits that a higher nonperforming financing ratio diminishes bank profitability. This outcome aligns with studies by Al-Husainy and Jadah (2021) and Dewi and Badjra (2020), which also reported a detrimental effect of nonperforming loans on ROA. The explanation for this negative relationship lies in the relatively high-profit margins applied by Islamic banks, leading to higher customer defaults and greater losses. These defaults hurt the banks' financial health, reducing their overall profitability.

Conversely, the financing-to-asset ratio demonstrated a positive, albeit statistically insignificant, effect on ROA, with a coefficient of 0.002. This result corroborates the second hypothesis that suggests a positive correlation between a bank's ability to extend financing and its profitability. The positive association is consistent with studies such as Boahene, Dasah and Agyei (2012), and Kolapo, Ayeni, and Oke (2012), which emphasize the role of lending in enhancing bank profitability. This relationship indicates that banks with substantial assets are better positioned to grant more financing, thereby increasing their income through profit margins.

Lastly, the capital adequacy ratio was found to have a positive impact on ROA, with a coefficient of 0.034, supporting the third hypothesis. Although this effect is not statistically significant, it highlights the importance of a robust capital base in mitigating financing risk and sustaining profitability. This finding resonates with studies by Akbar (2018) and Muawanah and Imronudin (2021), who observed a similar positive association in the context of Indonesian Islamic banks. Banks with adequate capital are better equipped to absorb potential losses, which enhances their financial resilience and ability to generate returns.

The study suggests that Islamic banks can enhance profitability by maintaining high asset quality and a robust capital base. However, the statistical insignificance of some variables points to the need for further research to explore additional factors influencing profitability, such as operational efficiency and market conditions. Future studies could also investigate the impact of regulatory changes and macroeconomic variables on the relationship between financing risk and profitability in Islamic banks across different regions. Additionally, examining the role of technological innovations, such as fintech, in managing financing risks could provide valuable insights for enhancing the operational strategies of Islamic banks.

CONCLUSIONS

This study aimed to examine the impact of financing risk on the financial performance of Islamic banks in the MENA region by analyzing data from 14 banks over the period 2013 to 2022. The results demonstrate that the financing-to-asset ratio and the capital adequacy ratio have a positive influence on the return on assets, indicating that banks with higher levels of financing relative to their assets and stronger capital positions tend to achieve better financial performance. Conversely, the nonperforming financing ratio hurts profitability, underscoring the adverse effect of impaired financing on banks' bottom lines.

The study's findings make unique contributions by providing empirical evidence on the importance of financing risk management in enhancing the profitability of Islamic banks. The results underscore the critical role of maintaining a robust capital base and effective asset management strategies in mitigating risk and sustaining financial stability. These insights are particularly relevant for bank managers and policymakers, as they underscore the need for rigorous credit risk management and the adoption of practices that safeguard against high levels of nonperforming financing.

In terms of practical implications, Islamic banks should prioritize the development of comprehensive risk management frameworks that include portfolio diversification, stricter credit assessment procedures, and dynamic capital adequacy policies. By doing so, banks can enhance their resilience against potential losses and ensure sustainable growth.

However, the study has certain limitations. The analysis is restricted to banks within the MENA region and relies on specific financial indicators, potentially limiting the generalizability of the findings. Future research could expand the scope to include Islamic banks from other regions and incorporate additional variables such as market conditions, regulatory influences, and technological advancements. Moreover, exploring the role of digital innovations and fintech in managing financing risk could offer new perspectives on optimizing financial performance in the evolving banking landscape.

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