

The Influence of Foreign Islamic Banks in The Islamic Banking Industry

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ABSTRACT: This study explores the liquidity creation of 16 Islamic banks in Malaysia from 2008 to 2021. The primary objective of this study is to examine the determinants that contribute to the creation of liquidity in Islamic deposits, which is impacted by the influence of foreign Islamic banks' penetration in the Islamic banking industry. It is motivated by the pressing issue of underperforming conditions amongst foreign Islamic banks in recent years. This study adopts an econometric analysis using panel data regressions with a random effects model applying robust standard error. The finding shows a significant relationship between six independent variables: profit efficiency ratio, return on equity, capital adequacy ratio, bank concentration, financing to deposit ratio, and foreign Islamic banks, with the dependent variable of Islamic deposits. This is a strategic call and requires deliberate analysis to assist liquidity management in understanding the impact of bank-specific financial conditions on Islamic deposits. The study extends the liquidity creation theory by incorporating Shariah-compliant deposit structures and exploring the role of foreign Islamic bank penetration on deposit mobilization in Islamic banking.

Keywords: Deposit, Islamic deposits, Islamic bank, Bank deposit, Bank's liquidity.

■ INTRODUCTION

In academic literature, foreign banks' influence on local banks' behavior has received less consideration (Ghosh 2016). According to Ghosh's (2016) findings, the existing references substantiate the proposition that foreign banks have significant spillover effects, leading to a reduction in lending by local banks. This finding implies that the banking sector's stability tends to decline over time as more foreign banks enter the market. Research by Hassan *et al.* (2013) examines the effects of financial liberalization and the formation of foreign Islamic banks on the performance of local Islamic banks. The findings suggest that foreign Islamic banks adopt a more appealing financing strategy while maintaining favorable profit margins, and one of the significant financing sources is deposits. Thus, the financial viability of foreign Islamic banks has considerable importance in shaping the decision-making of local Islamic banks.

The penetration of foreign Islamic banks has resulted in increased competition and less concentration within the market structure of Islamic banking. Local Islamic banks must be more adaptable in dealing with this new market structure's potential hazards and issues (Basri 2020). However, in addition to the introduction of foreign Islamic banks, various factors, including mergers among local banks, changes in monetary policy by the central bank, improvements in the regulatory framework, the potential risk of a COVID-19 pandemic resurgence, prevailing economic uncertainties, escalating political conflicts, the threat of catastrophic climate change, and the underwhelming labor market conditions may significantly impact the market dynamics of the Islamic banking

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industry. Consequently, the new competitive Islamic banking market structure warrants further examination and discussion.

Unlike conventional deposits, Islamic deposits are established based on Shariah contracts such as Wadiah, Qard, Mudarabah, and Commodity Murabahah (Tawarruq). Their operation is governed by Shariah principles that prohibit interest (riba) and emphasise profit-sharing, asset-backed transactions, and ethical financial practices. Depositors' behaviour is therefore influenced not only by financial returns but also by religious compliance, trust, and confidence in Shariah governance. These distinctive characteristics suggest that the determinants of Islamic deposits may differ from those of conventional deposits and therefore warrant separate empirical investigation rather than assuming that evidence from conventional banking can be directly generalised to Islamic banking.

Although previous studies have extensively examined Islamic bank profitability, efficiency, financing activities, and competition (Sufian & Haron 2008; Sufian 2010; Hassan *et al.* 2013; Basri 2020), considerably less attention has been devoted to the determinants of Islamic deposit liquidity creation, particularly in the context of foreign Islamic bank participation. Existing studies primarily evaluate the overall performance of Islamic banks without distinguishing the deposit mobilisation function or comparing the behaviour of foreign and domestic Islamic banks. Consequently, empirical evidence explaining how foreign Islamic banks influence

Islamic deposit creation and the bank-specific factors that determine deposit liquidity remains limited.

In recent years, it has been observed that foreign Islamic banks have shown unsatisfactory performance, demonstrating lower levels of profitability and performance compared to local Islamic banks (Saw *et al.* 2023; Basri 2020). Several foreign Islamic banks operating in Malaysia have experienced financial difficulties and, in some cases, have been forced to cease operations (Saw *et al.* 2023). From a policy-maker standpoint, allowing foreign Islamic banks to enter the Malaysian Islamic banking industry is paramount to enhancing productivity and efficiency (Sufian 2010). However, in light of the heightened rivalry, foreign and minor local Islamic banks must improve their productivity and efficiency to sustain competitiveness, profitability, and survival (Sufian & Haron 2008). As competition within the Islamic banking industry grows, smaller banks, such as foreign Islamic banks, must exert significant efforts to increase business volumes and strengthen their positions. For instance, the entrance of foreign banks into the market is encouragingly influencing the growth of Islamic products, such as Islamic bank deposits. As a result, foreign Islamic product developments may pose substantial challenges to the local Islamic banking industry, whose operating environment has changed swiftly, inevitably affecting their performance.

In Malaysia, it is evidenced that foreign Islamic banks often encounter lower deposits than their domestic counterparts. According to the data shown in Figure 1,

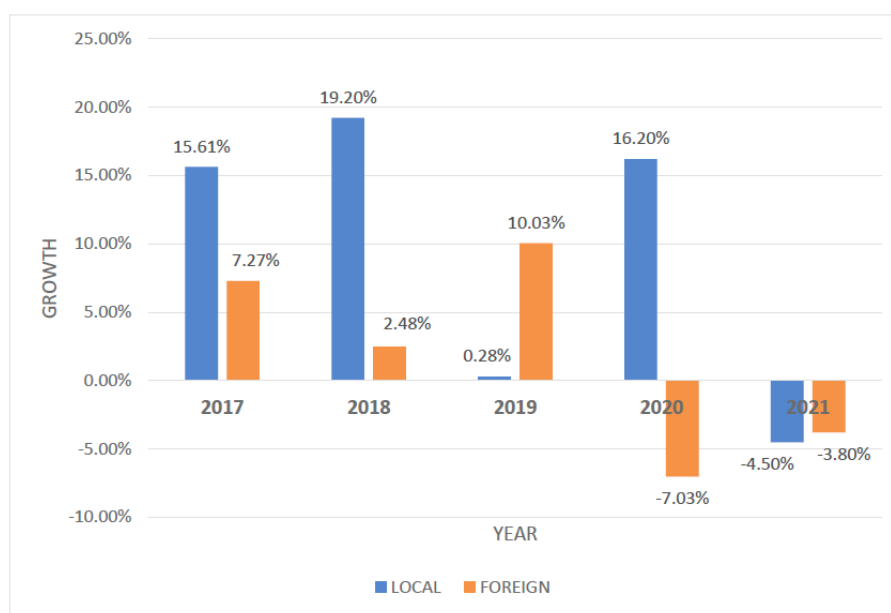


Figure 1: Total deposits growth between local and foreign Islamic banks, 2017 – 2021. Source: Authors' calculation using original data from Annual Reports, Islamic banks of Malaysia

there has been a notable rise in the growth of Islamic deposits in local Islamic banks, reaching 16.20% in 2020. However, this growth spotted a decline in 2021, dropping to -4.50%. Conversely, foreign Islamic banks witnessed a fall in growth, reaching -7.03% in 2020. Nevertheless, there was a subsequent recovery in 2021, with the growth rate recorded at -3.80%. The review of growth from 2017 to 2021 reveals that liquidity creation for local Islamic bank deposits has seen fluctuating growth, with a significant impact from the COVID-19 pandemic circumstances in 2021. The analysis indicates that the liquidity creation of foreign Islamic bank deposits is comparatively less competitive than local Islamic banks.

Against this backdrop, this study examines the determinants of liquidity creation through Islamic deposits, with particular emphasis on the influence of foreign Islamic banks in Malaysia. Specifically, the study investigates whether bank-specific characteristics explain Islamic deposit creation differently between foreign and domestic Islamic banks. By focusing on Islamic deposits rather than overall bank performance, this study extends the existing literature in two important ways. First, it provides empirical evidence on the determinants of Islamic deposit liquidity creation, an area that remains underexplored. Second, it offers new insights into how the participation of foreign Islamic banks shapes deposit mobilisation and liquidity creation within Malaysia's dual banking system, thereby contributing to the literature on Islamic banking competition and financial intermediation.

The remainder of this paper is organised as follows. Section 2 reviews the relevant literature, while Section 3 develops the research hypotheses. Section 4 describes the research methodology and empirical model. Section 5 presents and discusses the empirical findings, including robustness analyses. Finally, Section 6 concludes the study and outlines policy implications.

■ LITERATURE REVIEW

■ Liquidity Creation Theory

Bank deposits are regarded as a fundamental element in the creation of liquidity (Mdghri and Oubdi, 2022). Diamond and Rajan (1999, 2000) modeled a partnership concept for banks' financial fragility where banks raise investors' funds to provide financing for entrepreneurs. Through this partnership concept, a liquidity problem may arise when borrowers (*i.e.*, entrepreneurs) refuse or withhold their repayment on demand. Banks can overcome this liquidity issue by taking on more deposits while reducing their capital structure. However, having a

fragile capital structure and greater deposits are subject to "bank runs" because deposits are prone to be run by depositors, especially in the event of a bank's financial crisis (this situation is known as "financial fragility structure – crowding out deposits"). Gorton and Winton (2017) believed that a stronger capital structure could reduce liquidity creation since a higher capital ratio would lower the creation of liquidity in the bank. Besides, the bank's capital providers, such as investors, are not subject to "bank runs" like depositors. Nevertheless, a deposit contract mitigates the funding withholding by the borrower because, through depositors, the bank can maximize the creation of liquidity. Liquidity creation theory stipulates that creating bank deposits in a short-term maturity structure is more liquid than other assets and provides customers with liquidity ease. The past literature on the theory of liquidity creation has focused primarily on conventional deposits rather than on Islamic deposits.

From the perspective of Islamic banking principles, the theoretical model of Islamic banks may effectively fill conventional banks' failure to sustain stability (Khan 1987). The foundation model of Islamic banks operates under the principles of Islamic law (Shariah), which forbids the payment or receipt of interest (*riba*) and promotes risk sharing. In Malaysia, the Islamic Financial Services Act 2013 (IFSA 2013) redefines Islamic deposits, and Islamic banks must separate the funds placed by the customers into Islamic deposit and investment accounts. The deposit account is risk-free since Shariah contracts guarantee the principal. In contrast, the investment account is vulnerable to loss because the principal return or profit is not guaranteed. Nevertheless, implementing IFSA 2013 may have unforeseen implications for depositors or investors, such as decreased profit payouts and "withdrawal risk," which arises when depositors or investors withdraw their funds and switch to other financial products (Budiman *et al.* 2019). Hence, Islamic banks may also experience bank runs, resulting in illiquidity issues too.

The management of liquidity is crucial in both conventional and Islamic banking. However, the difference in Islamic banks is unique and even more challenging because the instruments used for liquidity creation, such as deposits, are not interest-based for Islamic banks. Unlike conventional deposits, Islamic deposits are governed by Shariah contracts such as *Wadiah*, *Qard* and *Tawarruq*. These contracts influence depositor expectations, withdrawal behaviour and liquidity management, thereby affecting liquidity creation mechanisms in Islamic banks. As Mohammad *et al.*

(2020) stated, liquidity creation issues have not been empirically studied within Islamic banking and finance.

■ HYPOTHESES DEVELOPMENT

■ The Islamic Deposits – Dependent Variable

A bank deposit refers to the monetary sum that a client maintains in their account, for which the bank provides the customer with a predetermined profit rate determined by the current prevailing rate (Mushtaq & Siddiqui, 2017). A deposit in an Islamic bank refers to an account held with a banking institution that operates in accordance with the principles of Islamic law, often known as Shariah. The management of these accounts adheres to Islamic banking principles, which strictly restrict the accumulation and disbursement of interest. Islamic banks adhere to a fundamental concept of profit and loss sharing, wherein the bank's investments are subject to a distribution of profits between the bank itself and its depositors.

■ The Islamic Bank-Specific Financial Factors - Independent Variables

Bank-specific financial factors considered independent variables in this study include profitability (profit efficiency ratio and return on equity), capital adequacy ratio, bank concentration, and financing-to-deposit ratio. This study also includes a dummy variable representing foreign Islamic banks' influence on Islamic deposits' liquidity creation.

■ Profitability

Fah and Hassani (2014) suggested that investors and depositors may use a bank's profitability performance to guide their decisions. The authors reported positive and significant relationships between deposits and banks' profitability and found the volatility of deposits does not significantly impact banks' profit efficiency in Malaysia. Nevertheless, a higher level of profitability can minimize the risk of default and enable banks to provide a lower rate of deposits. Hence, this study introduces one new independent variable of profit efficiency ratio (PER) representing the bank's profitability performance. Likewise, return on equity (ROE) is also a good indicator of business profitability in the banking sector. Feve *et al.* (2021) assume that acquiring equity costs more than generating deposits. Renfiana (2022) discovered the profit-sharing rate associated with mudharabah deposits, which favors the volume of deposits maintained by Islamic banks. As a result, this study examines the profitability parameters, such as PER and ROE, to identify Islamic banks' capacity to attract deposits.

Therefore, the following hypotheses are formed:

H₁. Profit efficiency ratio is positively correlated with Islamic deposits.

H₂. Return on equity is positively correlated with Islamic deposits.

■ Capital Adequacy Ratio

A bank's capital adequacy ratio (CAR) is the capital-to-risk weighted assets ratio. CAR may determine the bank's ability to create liquidity and safeguard depositors to enhance financial system performance. Previous research has shown a negative correlation between CAR and the proportion of deposits (Bateni *et al.* 2014). According to Berger and Udunov (2017), there is a need for a more profound comprehension of how different capitalization levels affect the availability of funds in banks. However, Rahman and Banna (2016) indicate that CAR has a positive and statistically significant relationship in conventional banks, but it is deemed unimportant in Islamic banks. This observation implies that the correlation between CAR and Islamic deposits may reveal variations according to the types of banks. Moreover, Junjuna *et al.* (2022) showed a notable disparity in CAR, indicating potential differences in the association between CAR and Islamic deposits during the global COVID-19 epidemic. Therefore, the following hypothesis is formed:

H₃. Capital adequacy ratios is positively correlated with Islamic deposits.

■ Bank Concentration - Herfindahl-Hirschman Index (HHI)

HHI has been frequently employed in past literature to describe competitiveness in the banking sector (Xia *et al.* 2021). Kamran *et al.* (2019) measured the HHI by summing the squares of the proportion of total deposits among all the assessed banks. Maji and Hazarika (2018) computed HHI using deposits, and the findings show that the higher the HHI, the more the concentration is in the market and the less competition there is. Furthermore, Drechsler *et al.* (2017) utilized the HHI measurement, which discovered a connection between bank behaviors during monetary policy changes and deposit-market concentration. This result suggests that a higher HHI indicates higher concentration, which may result in lower deposit levels. In the context of Islamic banking, Ab Rahman *et al.* (2021) found that bank concentration had a positive and statistically significant impact on Islamic bank deposits, indicating that factors related to bank performance and market structure can affect the

magnitude of Islamic deposits. Knowing how the Islamic banks' concentration determines the liquidity of Islamic deposits is substantial. Literally, higher market concentration may strengthen market power, enabling banks to attract deposits through stronger reputation effects and customer loyalty. Conversely, increased competition may fragment deposit markets and reduce deposit concentration. Therefore, the following hypothesis is formed:

H₄. Herfindahl-Hirschman Index is positively correlated with Islamic deposits.

■ **Financing-to-Deposit Ratio**

Financing to deposit ratio (FDR) terminology is favored by Islamic banks to fulfil Shariah compliance requirements. FDR represents the liquidity level of a bank. The FDR aims to determine how much a bank uses deposits for financing activities. Prior 2000s banks in Malaysia typically relied on customers' deposits from retail and wholesale sectors, and during the millennium year, up to 82% of all funding activities were from bank deposits (Linn & Ang 2016). Measurement of FDR is employed to measure the banks' liquidity composition based on the ratio of total Shariah financing divided by the amount of Islamic deposit funds collected from customers (Aswan et al., 2017; Munir, 2018; Nugroho et al., 2021). FDR has significantly influenced on the profit-sharing rate of Mudharabah deposits (Oktaviani & Riyadi 2021). If the ratio is too high, it indicates that the bank has deficiencies in liquidity to cover its short-term financing requirements. In contrast, a bank may not generate as much funds as it might if the ratio is too low. Hence, it is imperative to analyze and examine the correlation between the FDR and Islamic deposits, as this relationship may serve as a crucial means of evaluating a bank's liquidity and financial well-being. Therefore, the following hypothesis is formed:

H₅. Financing-to-deposit ratio is negatively correlated with Islamic deposits.

■ **Foreign Islamic banks**

Existing research has shown that local Islamic banks perform better than their foreign counterparts (Abbas et al. 2017; Basri 2020; Kabir Hassan et al. 2013; Kamarudin et al. 2017; Saw et al. 2023; Sufian 2010). By reviewing the perspective of the performance between local and foreign Islamic banks, the existing studies have generally concentrated on a bank's profitability and stability, with little attention paid to the bank's liquidity performance. On another note, previous studies on the factors that affect Islamic deposits' liquidity mainly focus on all Islamic banks without distinguishing between local and foreign Islamic banks, such as studies by Abduh et al. (2011), Ab Rahman et al. (2021), and Solarin et al. (2018). As of yet, the examination of the liquidity performance of Islamic deposits in the presence of foreign Islamic banks is scanty. Thus, this paper aims to extend the research findings on Islamic deposits by introducing this new perspective. Besides, it is probable to have different determinants impact on the liquidity of Islamic deposits after the penetration of foreign Islamic banks. Looking back, foreign banks in Malaysia recorded operational losses in 2010-2011 and 2015-2016, with foreign Islamic banks having struggled performances in recent years (Saw et al., 2023). Thus, this creates urgency and motivates this study to focus on the determinant variable of the liquidity creation of Islamic bank deposits after the influence of foreign Islamic banks' penetration. Therefore, the following hypothesis is formed:

H₆. Foreign Islamic banks is negatively correlated with Islamic deposits.

The following Figure 2 depicts the research framework in this study.

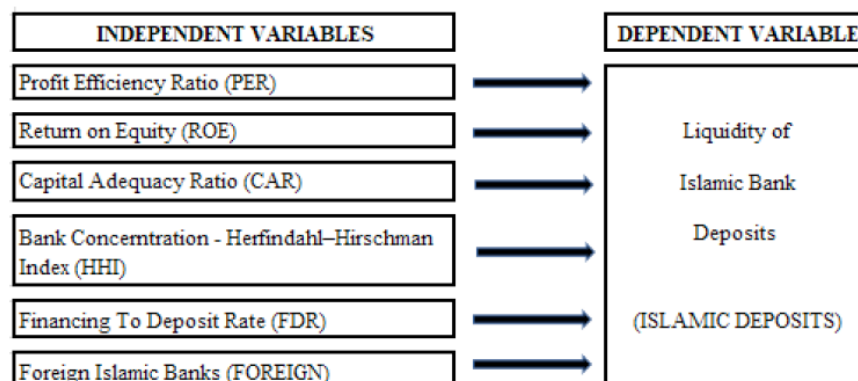


Figure 2: Research Framework.

METHODOLOGY

Data Sampling

This study analyzed the variables determining Islamic deposits' liquidity by examining Malaysia's local and foreign Islamic banks. This study uses data from a sample of 16 Islamic banks in Malaysia, 11 local and five foreign Islamic banks. Balanced panel data include 224 (154 local and 70 foreign) observations covering the years from 2008 until 2021. All 16 Islamic banks have been completely incorporated since 2008, with just eight Islamic banks operating in Malaysia prior to 2008. The data was studied and analyzed in 2022; hence, the examined period only extends to 2021. The data is longitudinal and gathered from secondary sources, such as the Financial Reports of Malaysian Islamic banks.

This study adopts an econometric analysis using panel data correlation and regression. As an econometric method, descriptive statistics, the skewness and kurtosis test for examining the data distribution, and the Pearson correlation matrix test for assessing the multicollinearity of examined variables are utilized to evaluate the robustness of the data. Beforehand, data screening is performed to identify outliers using a scatter plot, and the results demonstrate that the data is normally distributed. Furthermore, the Breusch-Pagan LM, and the Hausman tests are employed to check the fittingness of using panel data regressions with either pooled ordinary least square, fixed, or random effects. In order to evade the issue often referred to as the dummy variable trap, this study dropped the local Islamic bank dummy and only employed one dummy variable in the equation, which is foreign Islamic bank. Accordingly, the empirical model in this study measures the determinants of Islamic bank deposits' liquidity by utilizing panel data regressions with robust standard error. It should be noted that for the sensitivity test, this study uses an additional test by using a robust command option to cater the heteroskedasticity problem. Thus, the statistical findings in this study may provide an answer to the research objective.

Empirical Model Specification

In order to examine the association between the dependent variable, which is the liquidity of Islamic bank deposits (ID), and its six independent variables, the following panel data regression model is formed for this study.

$$ID_{it} = \beta_0 + \beta_1 PER_{it} + \beta_2 ROE_{it} + \beta_3 CAR_{it} + \beta_4 HHI_{it} + \beta_5 FDR_{it} + \beta_6 FOREIGN_{it} + \varepsilon_{it}$$

Where,

Dependent variable:

$$ID_{it} = \text{Islamic Deposits}$$

Independent Variables:

$$\beta_1 PER_{it} = \text{Profit Efficiency Ratio}$$

$$\beta_2 ROE_{it} = \text{Return on Equity}$$

$$\beta_3 CAR_{it} = \text{Capital Adequacy Ratio}$$

$$\beta_4 HHI_{it} = \text{Bank Concentration: Herfindahl-Hirschman Index (HHI)}$$

$$\beta_5 FDR_{it} = \text{Financing-to-Deposit Ratio}$$

$$\beta_6 FOREIGN_{it} = \text{Foreign Islamic Banks (dummy variable)}$$

The following Table 1 summarizes the variables information involved in the study. The measurements of the variables are derived from the authors' calculations using secondary data taken from the Financial Reports of Islamic banks. The natural logarithm of Islamic deposits is used to reduce skewness and improve comparability across banks of different sizes.

RESULTS AND FINDINGS

Descriptive Data Analysis

Table 2 shows the descriptive data for the variables studied from all 11 local and five foreign Islamic banks

Table 2 shows all variables exhibit low standard deviation, which indicates slight variation among all 16 Islamic banks, regardless of the type of bank. The proportion of Islamic deposits in the local Islamic banks' ranges from the lowest log value of 13.71 (or RM 899,865 billion) to the high log value of 19.01 (or RM 180,276,077 billion). The ranges for the foreign Islamic banks are between 14.09 (or RM 1,315,859 billion) and 16.40 (or RM 13,256,519 billion). The maximum values of Islamic deposits between 16.40 (foreign) and 19.01 (local) show that foreign Islamic deposits are underperforming in terms of deposits' liquidity creation in the long run. Notwithstanding the underperformed liquidity creation of deposits in foreign Islamic banks, its' average value score of PER is at 0.81, which signifies better profit efficiencies than local counterparts only at 0.53. Even so, foreign Islamic banks are able to exceed local Islamic banks in profit efficiency, as the maximum value at 0.31 of PER is much higher than local Islamic banks, which only score

Table 1: Summary of the Variable's Information

Variables	Measurements
Dependent Variable:	
Islamic deposits (ID)	Natural logarithms of total Islamic bank deposits.
Independent Variables:	
Profit efficiency ratio (PER)	Total non-interest expense is divided by total net income.
Return on equity (ROE)	Total net profit before taxes and zakat is divided by total equities.
Capital Adequacy ratio (CAR)	Capital adequacy ratios is measured by the CET1 @Tier 1.
Bank Concentration: Herfindahl–Hirschman Index (HHI)	$HHI = \sum_{i=1}^n \left(\frac{\sum \text{Deposits}}{\sum \text{Market Deposits}} \right)^2$ HHI is measured by summing the squares of the proportion of total deposits among all the assessed Islamic banks.
Financing-to-deposit ratio (FDR)	Total Shariah financing is divided by total Islamic bank deposits.
Foreign Islamic banks (FOREIGN)	The dummy measurement uses a binary variable, wherein a value of "1" indicates that the Islamic bank is foreign, while a value of "0" indicates that it is local. The model specification excludes the local Islamic bank dummy and uses it as the base for the foreign dummy in the regression model.

Table 2: Descriptive Statistics

	Islamic Deposits	PER	ROE	CAR	HHI	FDR
Local Islamic Banks						
Mean	16.80	0.53	0.13	0.14	0.01	0.89
Std. dev.	1.10	0.30	0.07	0.08	0.02	0.27
Min	13.71	0.01	-0.07	0.07	0.00	0.26
Max	19.01	2.72	0.31	0.90	0.08	2.76
Foreign Islamic Banks						
Mean	15.44	0.81	0.05	0.16	0.00	1.13
Std. dev.	0.56	0.64	0.09	0.06	0.00	0.42
Min	14.09	-0.40	-0.43	0.07	0.00	0.02
Max	16.40	5.13	0.23	0.38	0.00	2.79

2.72. However, foreign Islamic banks show a much lower loss of PER at -0.40, while local Islamic banks maintain a positive profit efficiency at 0.01.

The standard deviation of ROE between both types of banks is relatively in the closer range, with an average value of 0.05 (foreign) and 0.13 (local). These scores signify an unimpressive indicator of business profitability in the long run, especially for foreign Islamic banks. Looking at the minimum ROE value, foreign Islamic banks score much lower returns as compared to local Islamic banks, with a lower negative minimum value of -0.43 (local: -0.07), and the maximum value of foreign presents much lower equity returns at 0.23 (local:0.31).

Both types of banks have a closer performance score in CAR's average value (foreign:0.16; local:0.14). The CAR average score of 0.14 (or 14%) for local and 0.16 (or 16%) for foreign indicates that all Islamic banks in Malaysia are well-capitalized, higher than the 8% required by BASEL III international standards. The results also demonstrate that the HHI average score between foreign and local are at 0.01 and 0.00, respectively, which implies less concentration concerning Islamic deposits market structure between all Islamic banks in Malaysia. Lastly, for the FDR, the local average score is 0.89, meaning the local Islamic banks are able to offer financing 0.89 times more than the volume of deposits. In contrast, foreign Islamic banks are able to offer higher

Table 3: Normality Test

	Islamic Deposits	PER	ROE	CAR	HHI	FDR	FOREIGN
Skewness	0.4908	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
Kurtosis	0.0939	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

financing at 1.13 times more than the volume of deposits, with an FDR average of 1.13.

In comparison between foreign and local Islamic banks, by looking at the presented descriptive statistics in Table 2, the results of foreign Islamic banks are not well performed in specific performance indicators such as by showing a lower liquidity creation in Islamic deposits, much lower loss in profit efficiency, and lower returns in equity as compared to the local Islamic banks. The descriptive results are presented in the ratio or percentage and not in level form value of the original data; thus, the comparison is considered unbiased.

■ Empirical Findings

Table 4: Variance Inflation Factor (VIF)

Variable	VIF
ROE	1.68
PER	1.54
FOREIGN	1.44
CAR	1.29
HHI	1.27
FDR	1.15
Mean VIF	1.40

Notes: Mean VIF less than 10 indicates no multicollinearity problem.

This section explains different econometric tests that are carried out to verify the reliability of the variables. Skewness and kurtosis criteria are used to check the

data's normalcy. The results from Table 3 show the skewness range from 0.00 to 0.49, and the coefficient of kurtosis is from 0.00 to 0.94. The skewness values for data with a normal distribution should ideally be close to 0. According to George and Mallery (2010) and Hair *et al.* (2010), skewness and kurtosis values falling within the range of -2 to +2 are considered to be within the normal and acceptable range for a univariate distribution. The results of VIF indicate the examined variables have no multicollinearity issues, as shown in Table 4.

The Pearson correlation matrix is employed to examine multicollinearity in normally distributed data. Many authors (Brooks 2008; Haniffa & Cooke 2005; Li *et al.* 2008) set a correlation criterion at 0.8 as a cut-off point. The results in Table 5 show that the variables' correlation is not highly correlated.

The Hausman test evaluates panel data regressions, either fixed or random effects. The Hausman test in Table 6 accepts the null hypothesis (0.0758; $p > 0.05$). This indicates that fixed effects model is not appropriate and that random effect is the preferred method for evaluating local Islamic bank deposit determinants. Random effects are appropriate because the study seeks to draw inference for the entire population of Islamic banks operating in Malaysia rather than focusing on individual bank-specific effects. The ownership structure and institutional characteristics are assumed to be randomly distributed across banks. The R^2 is 0.6163, reflecting the model's high goodness of fit statistics.

Table 5: Pearson Correlation Results

	Islamic Deposits	PER	ROE	CAR	HHI	FDR	FOREIGN
Islamic Deposits	1						
PER	0.450	1					
ROE	0.567	-0.476	1				
CAR	-0.442	0.459	-0.310	1			
HHI	0.617	-0.210	0.428	-0.126	1		
FDR	-0.111	0.018	-0.129	0.036	0.009	1	
FOREIGN	-0.547	0.288	-0.441	0.111	-0.310	0.325	1

Table 6: Panel Data Regressions of Random Effects Model with Robust Standard Error

Islamic Deposits	Coef.	z-value
PER	-0.203	-1.98***
ROE	0.165	0.26*
CAR	-2.402	-3.52***
HHI	0.832	6.03***
FDR	0.251	1.92***
FOREIGN	-0.892	-3.29***
_cons	16.571	68.81***
R-square		0.6163
Prob > Chi2		0.0000
Hausman test		0.0758
Obs No		224

Notes: *** p<0.01, ** p<0.05, * p<0.1.

Table 6 shows all six hypotheses of PER (H₁), ROE (H₂), CAR (H₃), HHI (H₄), FDR (H₅), and FOREIGN (H₆) provide significant results. PER, CAR, HHI, FDR, and FOREIGN variables are significant at a 1% level, except for ROE, which is significant at a 10% level.

Regarding H₁, the empirical results show a negative association of profitability for variable PER with the liquidity of Islamic bank deposits. This result is inconsistent with the predicted H₁, although a significant effect coefficient is identified. The findings signify that the liquidity of Islamic deposits is negatively affected by the profit efficiency determinant. This is the first attempt in academic research to utilize the relationship between the profit efficiency ratio and the liquidity creation of bank deposits, specifically in Islamic banks. However, this study confirms the H₂ of a profitability relationship between ROE and deposits in Islamic banks, as a positive significant coefficient is seen. This result parallels studies by Unvan and Yakubu (2020) and Renfiana (2022), verifying that consumers are encouraged to allocate their savings to Islamic banks by considering their profitability. Existing research has utilized several profitability metrics, such as ROE and profit-sharing rate, to predict bank deposits. Thus, inconsistencies in the profitability factor utilized in earlier research provide disparate conclusions. As a result, the data from H₁ and H₂ suggest that not all profitability criteria may favorably improve the liquidity of Islamic deposits. Given that the significant level of coefficients for ROE is 10%, this study strongly suggests that Islamic banks improve their ROE because it is more beneficial in attracting Islamic deposits from clients.

In verifying H₃, CAR is negatively and significantly associated with the Islamic deposits, with a coefficient value of -2.402. The results indicate a 1percent increase in the stringency of capital requirements for banks, resulting in a -2.4 percent decrease in the liquidity creation of Islamic bank deposits. This result is supported by Ab Rahman *et al.* (2021) and Bateni *et al.* (2014), but not supported by Abdul Karim *et al.* (2014). These findings indicate that Islamic banks can generate more deposits with lower CAR. Therefore, foreign Islamic banks may lessen their CAR to create more liquidity through deposits to be as competitive as local Islamic banks' deposits. The relationships between CAR and Islamic bank deposits correspond with the liquidity creation theory, which showed that increasing capital ratios would reduce the output of liquidity through crowding out deposits.

Regarding H₄, the empirical findings confirm the hypothesized H₄ by revealing a substantial positive coefficient, suggesting a positive relationship between HHI and the liquidity of Islamic deposits. This conclusion is consistent with the findings of Kamran *et al.* (2019), who calculated the HHI by adding the squares of the proportion of total deposits held by each of the banks assessed. Regarding the relationship between the market concentration of Islamic deposits and liquidity creation, the empirical data in Table 6 show that a 1 percent rise in the HHI produces a 0.832 percent increase in liquidity creation in Islamic bank deposits. According to Ab Rahman *et al.* (2021), HHI for both types of banks in this study is positively significant to Islamic bank deposits. Due to the empirical findings of random effect regressions, a higher concentration of Islamic deposits in the banking market structure tends to boost the banks' liquidity creation. This study shows that increasing resource concentration may be associated with improved bank performance, perhaps encouraging larger deposit inflows.

FDR is favorably and strongly related to Islamic deposits, according to H₅, with a coefficient value of 0.251. This research suggests that a 1 percent rise in the FDR correlates to a 0.251 increase in Islamic deposits. These empirical findings suggest that a higher degree of FDR has a beneficial effect on liquidity generation in the case of Islamic deposits. The positive coefficient of FDR suggests that Islamic banks with higher financing activities are able to attract and sustain larger deposit volumes. This finding indicates that financing expansion may enhance depositor confidence and contribute positively to liquidity creation. This conclusion, however, contradicts the findings of Ab Rahman *et al.* (2021).

Consequently, this finding implies that more customer financing leads to bigger Islamic deposits. The FDR seeks to ascertain how much a bank utilizes deposits to finance its operations. A higher FDR indicates that a bank depends more on deposits to finance its assets. In the event that the ratio is excessively higher, the bank lacks the necessary liquidity to fulfill its immediate financing obligations. On the contrary, in the event that the ratio is very low, a bank may see a decrease in profitability.

Consistent with H_6 , the FOREIGN result signifies that foreign Islamic banks negatively and significantly affected the liquidity of Islamic deposits. According to the findings, a 1 percent rise in the examined foreign Islamic bank reduces the liquidity created by Islamic deposits in the Islamic banking sector by -0.892%. Thus, the relationships between foreign Islamic banks and local Islamic bank deposits show that the increase of Islamic deposits in foreign Islamic banks would reduce the creation of liquidity in the local Islamic banking industry. This hypothesis's conclusions contradict those of Adam-Kane *et al.* (2017), Claessens and Van Horen (2014), and Ghosh (2016). Other prior studies, such as Basri (2020), Sufian (2010), and Sufian and Haron (2008), imply that foreign bank rivalry has decentralized the banking market structure and that these rivalries have posed substantial obstacles to the performance of local Islamic banks. This is the imperative reason behind the significant reasons for this study to be examined.

■ Sensitivity Tests

To test the robustness of the analyzed random effects model (RE) in Table 6, assessing the determinants of Islamic bank deposits is investigated in two additional models: the pooled ordinary least squares model (OLS) and the fixed effects model (FE). The Breusch-Pagan LM test distinguishes between pooled OLS and RE models. The p-value is less than 0.05, indicating that the RE model is more suitable than the OLS model. In other words, the data contains bank-specific effects. The Hausman specification test is often used in applied panel data analysis to evaluate whether a model is more suited, the RE model or the FE model. The Hausman test findings demonstrate that the p-value > 0.05 indicates failure to reject the null hypothesis; therefore, the random effects model is preferred. This shows that the RE model is adequate and that the FE model is not. The diagnostic tests show no serial correlation issue; however, there is a heteroskedasticity concern. The heteroskedasticity diagnostic check determines that the null hypothesis is rejected (p-value < 0.05), indicating that the variances are not constant and that there is a heteroskedasticity issue.

The robust command option corrects the model misspecification (Hoechle 2014), which relaxes the assumption that the errors are interrelated (Law 2018).

Therefore, to verify the robustness of the outcomes from the random effects model in Table 6, this study does a second panel data regression analysis using the random effects model with robust option (RE ROBUST). The random effects (RE) results in Table 6 are consistent with the random effects robust (RE ROBUST) results in Table 7. Interesting to note is that the results of the coefficient correlations and the significant level are similar in the two presented models. However, the standard errors in parentheses differ slightly between the two models. The findings also reveal that the dependent and independent variables are still associated in the same direction.

Table 7: Panel Data Regressions with Random Effects Model Applying Robust Standard Error

Islamic Deposits	(RE)	(RE ROBUST)
PER	-0.203**	-0.203
	-0.102	-0.157
ROE	0.165	0.165
	-0.637	-1.199
CAR	-2.402***	-2.402***
	-0.682	-0.912
HHI	37.64***	37.64***
	-6.237	-8.975
FDR	0.251*	0.251
	-0.13	-0.231
FOREIGN	-0.892***	-0.892***
	-0.271	-0.307
Constant	16.57***	16.57***
	-0.241	-0.349
Observations	224	224
Number of Banks	16	16
R-squared	0.6163	0.6163
Prob>Chi2	0.0000	0.0000
Breusch-Pagan LM test	0.0000	
Hausman test	0.0758	
Heteroskedasticity	0.0000	

Note: Standard errors in parentheses * p<0.05, ** p<0.01, *** p<0.001.

■ DISCUSSION AND CONCLUSION

This study addresses a gap in the literature by providing new theoretical insights and empirical evidence regarding the impact of bank-specific financial factors and foreign

Islamic banks on Islamic bank deposits. Our findings show a significant relationship between six independent variables: profit efficiency ratio, return on equity, capital adequacy ratio, bank concentration, financing to deposit ratio, and foreign Islamic banks, with the dependent variable of Islamic deposits.

The profitability factor is the most commonly used tool to measure a bank's performance since it is the primary traditional function of a bank's major stability. Profitability can describe the high or low level of effectiveness in a bank's management. Depositors may use a bank's profitability and performance outcomes to guide their decision-making regarding the efficacy of current strategies and areas of improvement and identify promising avenues for growth. Therefore, in line with the theory of liquidity creation, this finding highlights how crucial it is for Islamic banks as financial liquidators to consistently maintain a positive and encouraging profitability efficiency to keep existing depositors and draw in new depositors. Moreover, given that the significant level of coefficients for return on equity (ROE) is 10%, this study strongly suggests that Islamic banks to improve their ROE because it is more beneficial in attracting Islamic deposits from clients. The positive ROE effect suggests that Islamic depositors respond to profitability signals despite the absence of guaranteed interest payments, supporting the profit-and-loss-sharing paradigm. Therefore, the new consistent findings from this study likewise suggest that a higher level of profitability, such as ROE, might minimize the risk of banks' default and enable banks to provide only a lower rate of deposits. According to Shariah compliance, it is deemed inappropriate for money to create income unless it is combined with human efforts and entails risk. Therefore, the profitability returns by Islamic banks, such as ROE, are rendering to the application of Islamic banking principles as it considers the distributable income to the investors and depositors.

The findings from this research signify that the capital adequacy ratio, as a proportion of risk-weighted credit exposures, can safeguard depositors and enhance financial system performance. Moreover, since deposits serve as a more effective liquidity buffer than equity capital investments, increasing capital ratios may encourage depositors to shift their money into the banks' equity rather than entirely leaving it. This is the imperative reason behind the significant relationship in this finding. Hence, the findings of this study confirm that the implementation of stringent capital restrictions has a detrimental impact on the ability of Islamic banks to generate liquidity via their deposit activities.

Bank concentration of Herfindahl–Hirschman Index (HHI) is a new significant determinant of Islamic banks' deposits. A higher Islamic bank with higher HHI can attract higher deposit-taking and create better liquidity. We expect local Islamic banks to use HHI to determine new potential growth opportunities for deposits. In contrast, foreign Islamic banks can assess the potential entry barriers in the Islamic banking market to improve their deposit growth rate. Therefore, the relationships between HHI and Islamic deposits are explained by a representation of banks' management, operational, and market competition. Nonetheless, knowing how the Islamic bank's concentration in Malaysia determines the liquidity of Islamic deposits is substantial.

The financing to deposit ratio (FDR) is a significant indicator of the bank's liquidity management. Notably, this result implies that by monitoring the FDR, Islamic banks are leveraging in order to remain competitive and earn higher returns. Islamic bank's leverage is between reducing their liquidity risk by holding more deposits or increasing their deposit mobilization in financing by giving better rates. Accordingly, the obtained results align with the financial liquidation theory, as applying more customer financing would promote a bank deposit and lead to bigger Islamic deposits.

From the findings, it can be concluded that foreign Islamic banks negatively and significantly affected the liquidity of Islamic deposits. The presence of foreign Islamic banks does not alone bring about advantageous outcomes. Policymakers such as Bank Negara Malaysia may strengthen supervisory monitoring of foreign Islamic banks to ensure sustainable deposit mobilization and liquidity resilience. Several limitations should be acknowledged. First, the sample is restricted to Islamic banks operating in Malaysia, which may limit generalizability to other jurisdictions. Second, the study focuses primarily on bank-specific determinants and excludes macroeconomic variables such as GDP growth, inflation and policy rates. Third, potential depositor behavioural factors, including trust, religiosity and financial literacy, could not be incorporated due to data limitations. Finally, the use of secondary annual data may not fully capture short-term fluctuations in deposit behaviour. The size of foreign banks may also be a pertinent factor to consider. Investigating these elements continues to be a key focus of future research endeavors.

■ MANAGERIAL RECOMMENDATIONS

The findings of this study offer several practical implications for the management of Islamic banks, particularly foreign Islamic banks operating in

increasingly competitive markets. Since profitability, capital adequacy, market concentration, financing-to-deposit ratio, and foreign bank ownership significantly influence Islamic deposits, bank managers should adopt integrated strategies that strengthen deposit mobilization while maintaining prudent liquidity management. First, management should enhance profitability through operational efficiency and sustainable income generation, as stronger financial performance improves depositor confidence and encourages greater deposit accumulation. Second, although maintaining adequate capital remains essential for financial resilience and regulatory compliance, managers should seek an optimal balance between capital adequacy and liquidity creation to avoid excessive capital holdings that may constrain deposit growth.

Furthermore, Islamic banks should strengthen their deposit mobilization strategies by introducing innovative Shariah-compliant deposit products, enhancing digital banking services, and improving customer engagement to build long-term depositor trust and loyalty. Given the significant role of the financing-to-deposit ratio, banks should continuously monitor financing expansion to ensure that financing activities are adequately supported by stable deposit growth, thereby minimizing liquidity risk while sustaining profitability. For foreign Islamic banks, whose deposits were found to be relatively less competitive than those of domestic Islamic banks, management should focus on strengthening brand reputation, improving service quality, expanding strategic partnerships, and offering differentiated value propositions that address local customer preferences while maintaining strict Shariah compliance. These initiatives would enhance customer confidence and improve competitiveness within the Malaysian Islamic banking industry.

Finally, Islamic bank management should leverage market intelligence and competitive analysis to better understand changes in market concentration and depositor behaviour. Continuous monitoring of industry dynamics, customer expectations, and emerging financial technologies will enable banks to respond proactively to changing market conditions and sustain long-term liquidity creation. Collectively, these managerial initiatives can strengthen deposit growth, improve liquidity resilience, and support the sustainable development of the Islamic banking sector.

■ IMPLICATION TO THEORY

According to Wilkins *et al.* (2019), the provisional nature of theories in the social sciences necessitates that

researchers refrain from making claims of definitive proof. This is due to the possibility of future studies yielding contradictory observations, as theories serve as logical models or frameworks that elucidate the behavior of interconnected phenomena, which can be empirically tested to allow for possible falsification. Hence, the findings and discussions in this study may not be a solid, proven representation of liquidity creation theory regarding the relationship between internal and external determinants of Islamic deposits in local and foreign Islamic banks. However, the strong foundation model from the Islamic banking principles, which allows bank deposits to operate under Islamic law (Shariah) principles, may effectively fill the sustainability of Islamic bank deposits' liquidity in the long run. This study has some generalizations and limitations, just like any other piece of research. Therefore, we hope that the statistical model and the hypotheses analyzed in this paper by reviewing past works of literature are able to support the theoretical arguments and logic, as well as the robustness-tested empirical findings where they are available.

■ CONFLICTS OF INTEREST

The author declared no conflicts of interest.

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