



The influence of prudential regulatory requirements on the financial stability of Tanzanian commercial banks

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ABSTRACT

This study examines the influence of prudential regulatory requirements on the financial stability of listed commercial banks in Tanzania. The study was guided by the financial intermediation theory, emphasizing the role played by financial institutions in reducing transaction costs as well as managing risks and improving the efficiency of operations. Using panel data analysis, the study focuses on three key regulatory measures, capital adequacy, liquidity, and asset quality requirements, while also considering bank-specific characteristics such as size and age. Using quarterly panel data for seven listed commercial banks for nine years, the study employs generalized least squares (GLS) to estimate the relationship between prudential indicators and financial stability. The results reveal that both capital adequacy and liquidity requirements have significant negative effects on financial stability, suggesting that in a developing financial system like Tanzania's, these rules may impose costs that erode profitability and reduce resilience. Asset quality requirements show a positive but statistically insignificant effect, indicating weak enforcement or delayed impact on stability. The study reveals that larger and older banks exhibit greater stability, underscoring the significance of scale and experience in fostering resilience. These findings underscore the need for context-specific prudential frameworks that balance regulatory safeguards with the realities of local banking markets, ensuring that compliance enhances rather than undermines stability. The study provides important policy insights for regulators and bank managers seeking to strengthen the Tanzanian financial system in line with both domestic needs and international standards. Specifically, there is a need for Tanzania's prudential regulation to be more context-specific and proportionate by adopting flexible, countercyclical capital and liquidity frameworks and strengthening enforcement of asset quality and risk management so that oversight enhances long-term financial stability without undermining efficiency and growth.

Keywords: Asset Quality Requirements, Capital Adequacy, Financial Stability, Liquidity, Tanzania

I. INTRODUCTION

The stability of the financial system is a cornerstone of sustainable economic growth and development (Awdeh et al., 2023). Commercial banks, in particular, play a critical role in mobilizing savings, allocating credit, and facilitating payments, making their stability vital for the wider economy (Fengju & Wubishet, 2024). To safeguard this stability, regulators impose prudential requirements such as capital adequacy, liquidity buffers, and asset quality standards (Haile et al., 2025). These requirements are designed to reduce risk-taking, enhance resilience to shocks, and protect depositors, thereby ensuring confidence in the banking sector (Abedin & Hossain, 2025). Globally, frameworks such as Basel I, II, and III have shaped regulatory standards, and countries like Tanzania have adopted versions of these rules to strengthen their financial systems (Haile et al., 2025). However, the effectiveness of such regulations often depends on the local context, including the maturity of financial markets, the capacity of banks, and the enforcement mechanisms available to supervisors.

Despite the clear rationale for prudential rules, their actual influence on bank stability in Tanzania remains a matter of concern. While regulations are expected to strengthen resilience, evidence suggests that they may also impose significant costs on banks, particularly in developing economies with shallow financial markets (Oke & Ikpesu, 2022; Sang, 2021). For instance, high capital and liquidity requirements may constrain banks' ability to extend credit, limit profitability, and ultimately reduce stability rather than enhance it (Olawale, 2024; Waqas & Bahrain, 2019). Moreover, enforcement of asset quality requirements has often been uneven, leading to doubts about their real effectiveness in mitigating credit risk (Kuria et al., 2024; Ariff & Shawtari, 2019).

The justification for this study lies in its potential to provide context-specific evidence that can guide policymakers, regulators, and bank managers. While international standards emphasize the universal importance of prudential rules, the Tanzanian experience highlights the need for tailored approaches that balance compliance with



market realities. This study contributes to a deeper understanding of the regulatory-stability nexus in a developing economy by empirically assessing how capital adequacy, liquidity, and asset quality requirements affect the stability of listed commercial banks. The findings are expected to inform not only the refinement of prudential policies in Tanzania but also broader debates on how global standards can be adapted to local banking systems. Ultimately, this research provides a critical evidence base for designing regulations that protect depositors and the financial system without undermining banks' long-term resilience and growth.

1.1 Statement of the Problem

Prudential regulatory requirements are critical in safeguarding the stability of banking system leading to enhancement of the performance of the country's financial system. These regulations play significance roles in promoting the stability, efficiency, and integrity of the banking system (Kuria et al., 2024). Bank of Tanzania issues these regulations in line with the Basel accords and require commercial banks to adhere to such requirements that emphasize capital adequacy, liquidity buffers, and asset quality standards. These regulations are intended to strengthen financial stability, protect depositors, and sustain confidence in the banking sector, which plays a central role in supporting economic growth and development.

Despite the enforcement of the prudential regulations in Tanzania, the actual influence of such regulatory requirements on the financial stability of Tanzanian commercial banks remains unclear. While some banks are performing well, the banking sector has experienced some notable distress, such as the closure of five commercial banks in 2018 due to persistent financial performance challenges. This raises questions on what the influence of prudential regulatory requirements on the financial stability of is Tanzanian commercial. Also, while such regulations aim at stabilising the banking system, their compliance may lead to higher costs which may limit bank's performance. It is therefore important to assess how capital adequacy, liquidity, and asset quality requirements influence the financial stability of Tanzanian commercial banks, while accounting for bank-specific characteristics such as size and age.

1.2 Research Objectives

The study aims at examining the influence of prudential regulatory requirements on the financial stability of Tanzanian Commercial Banks. Specifically, the study aims:

- i. to examines the effects of capital adequacy requirement on the financial stability of the commercial banks
- ii. to assess the effects of liquidity requirement on the financial stability of commercial banks
- iii. to examine the effects of asset quality requirement on the financial stability of commercial banks
- iv. to examine the effects of bank size on the financial stability of commercial banks.

II. LITERATURE REVIEW

2.1 Theoretical Review

This study is anchored in the Financial Intermediation Theory by Gurley and Shaw (1960). The theory explains the central role of banks as intermediaries between savers and borrowers. According to this theory, banks exist because they can reduce transaction costs, provide liquidity, and manage risks more efficiently than individual market participants. By mobilizing deposits and extending credit, banks transform short-term liabilities into long-term assets, a process that makes them vital for economic stability and growth. Also, efficiency and stability of financial institutions can be enhanced through financial intermediation (Ajabge & Usman, 2025). However, this same transformation exposes banks to risks such as liquidity shortages, credit defaults, and insolvency, making them particularly vulnerable to financial instability.

The relevance of this theory to the study lies in its emphasis on the importance of prudential regulation in supporting banks' intermediation function. Capital adequacy requirements are intended to ensure that banks maintain enough buffers to absorb shocks and protect depositors, thus sustaining confidence in the system. Liquidity requirements are designed to make banks capable of meeting withdrawal demands and maintaining smooth payment flows, while asset quality standards aim to reduce the risk of non-performing loans that threaten solvency. In essence, prudential rules complement the financial intermediation role of banks by addressing the inherent risks in transforming savings into credit. In the Tanzanian context, where banks are central to financing both businesses and households, understanding how these regulations affect financial stability provides valuable insights into whether prudential requirements strengthen or constrain the ability of banks to perform their intermediation function effectively.

2.2 Empirical Review

2.2.1 Studies Linking Capital Adequacy, Asset Quality, Liquidity, and Financial Stability

A large body of empirical literature has examined the role of prudential indicators such as capital adequacy, asset quality, and liquidity in enhancing financial stability across diverse banking systems. Sang (2021) found that the



capital adequacy ratio was a significant determinant of bank stability in Vietnam, emphasizing its importance in strengthening resilience. Similarly, Waqas and Bahrain (2019), in their study of commercial banks in Pakistan, highlighted how risk management, capital adequacy, and audit quality collectively bolster financial stability. In Nigeria, Oke and Ikpesu (2022) reported consistent evidence that capital adequacy and asset quality significantly affect the performance of the banking sector, linking stronger prudential compliance to improved stability. Extending this perspective, Olawale (2024) showed that capital adequacy supports resilience among Nigerian banks operating in volatile environments, while Chioma et al. (2021) revealed that inadequate management of capital adequacy risk and liquidity risk undermines the firm value of Nigerian deposit money banks.

The same pattern is evident in East Africa. Mirichii (2023) investigated deposit-taking SACCOs in Kenya and confirmed that capital adequacy, asset quality, management efficiency, earnings ability, and liquidity jointly influence financial performance, a proxy for stability. In a related study, Birisi et al. (2024) showed that capital adequacy is a key determinant of the stability of SACCOs in Kenya, reinforcing the prudential-stability link. Wanjiru et al. (2024) further confirmed that capital adequacy positively influences the financial performance of Kenyan commercial banks, demonstrating consistency across institutional types. Kuria et al. (2024) added that asset quality plays a critical role in the financial stability of Kenyan banks, showing how non-performing loans can undermine resilience. Comparative international evidence also supports these findings. Ariff and Shawtari (2019) emphasized that efficiency and asset quality are strongly tied to stability in Malaysia, while Bateni et al. (2014) identified capital adequacy determinants in Iranian banks that influence their overall performance. Collectively, these studies underscore that while capital adequacy and asset quality are central to resilience, their impact depends heavily on context-specific regulatory environments.

2.2.2 Studies Linking Prudential Indicators to Profitability and Performance Outcomes

Another group of studies has explored how prudential requirements shape profitability and financial performance, which in turn influence stability. Elviani and Sumarna (2024) analyzed the Indonesian banking sector and found that capital adequacy, asset quality, management quality, earnings quality, and liquidity significantly shape sector performance, illustrating how prudential compliance translates into better outcomes. Damayanti and Purwanto (2025), focusing on Bank Jateng, similarly showed that capital adequacy, asset quality, and liquidity directly influence profitability, which serves as a foundation for long-term stability. Samad and Geraldina (2024) also confirmed that asset quality and capital adequacy improve profitability in Indonesian banks, while GR (2025) evaluated Indian public sector banks and found that capital adequacy and asset quality significantly drive financial performance.

Regional studies provide further insights. Abba et al. (2018) identified the determinants of capital adequacy in Nigerian banks, arguing that maintaining adequate levels is necessary for sustaining profitability and competitiveness. Agustningsih and Muazaroh (2021) examined state-owned banks and revealed that liquidity, asset quality, profitability, and bank size are critical in shaping capital adequacy, highlighting interdependencies among prudential factors. Snjawi and Essa (2021) emphasized that liquidity indicators are crucial for assessing risk and enhancing capital adequacy, underscoring the balancing act between solvency and earnings. At a broader scale, Kusi et al. (2023) examined international evidence and showed how global capital requirements after the financial crisis improved bank stability, though the effects varied across regions. Ben Abdallah and Bahloul (2025) provided evidence from Tunisia that solvency and liquidity ratios influence profitability, with asset quality playing a moderating role. Collectively, these studies highlight that prudential indicators not only safeguard stability directly but also work indirectly through profitability and performance, making them essential tools for both regulators and bank managers.

Although extensive research has examined the role of capital adequacy, asset quality, and liquidity in influencing bank performance and stability across various countries, there remains a clear gap in context-specific evidence from Tanzania. Much of the existing literature originates from Asia, Nigeria, Kenya, and other regions, where financial markets, regulatory enforcement, and institutional capacities differ significantly from the Tanzanian setting. These studies consistently highlight the importance of prudential indicators, but they also show that their effects vary depending on the maturity of financial systems, enforcement strength, and market depth. Yet, very few studies directly investigate whether prudential requirements in Tanzania truly enhance financial stability or whether they impose unintended costs that weaken banks' resilience. This gap is critical because the Tanzanian banking sector operates in a developing economy with unique structural constraints, including shallow capital markets and evolving supervisory practices. Addressing this gap provides an opportunity to generate locally grounded evidence that can inform regulatory design, ensuring that prudential rules are adapted to Tanzania's realities rather than simply transplanted from international models.



III. METHODOLOGY

This study adopted a quantitative research design to assess the influence of prudential regulatory requirements on the financial stability of listed commercial banks in Tanzania. The analysis was based on quarterly panel data for the period 2015-2023, drawn from the published financial statements of commercial banks and complemented by data from the Bank of Tanzania. Financial stability was proxied by the Z-score, which captures the likelihood of bank insolvency by combining profitability, leverage, and volatility into a single indicator widely used in banking stability studies.

To examine the effect of prudential requirements, the study focused on five explanatory variables: capital adequacy requirement, liquidity requirement, asset quality requirement, bank size, and bank age. Capital adequacy requirement measured the level of a bank's capital relative to risk-weighted assets, while liquidity requirement reflected the proportion of liquid assets available to meet short-term obligations. Asset quality requirement was proxied by the ratio of non-performing loans to total loans, capturing the riskiness of banks' loan portfolios. Bank size was measured using the natural logarithm of total assets, representing economies of scale and diversification effects, while bank age was captured in terms of the number of years since establishment.

The study employed panel regression analysis to estimate the relationship between prudential indicators and financial stability. Specifically, the generalized least squares (GLS) estimation technique was applied to account for heteroscedasticity and potential cross-sectional correlation often present in panel data. This approach ensured efficient and unbiased estimates of the parameters. The empirical model was specified as follows:

$$Z_{it} = \beta_0 + \beta_1 CAR_{it} + \beta_2 LIQ_{it} + \beta_3 AQR_{it} + \beta_4 SIZE_{it} + \beta_5 AGE_{it} + \epsilon_{it}$$

Where Z_{it} denotes the financial stability of bank i at time t as proxied by the Z-score, CAR represents the capital adequacy requirement, LIQ the liquidity requirement, AQR the asset quality requirement, SIZE the bank size, and AGE the bank age. ϵ_{it} represents the error term. The variables CAR, LIQ and AQR were chosen in this study as they reflect the core regulatory concern of the Central Bank and the structural characteristics of domestic banking system.

The GLS regression was chosen because it corrects for heteroscedasticity and serial correlation in panel data, providing more robust results compared to ordinary least squares (OLS). The estimation results derived from this methodology formed the basis for analyzing the extent to which prudential regulations and bank-specific characteristics affect the stability of listed commercial banks in Tanzania.

IV. FINDINGS & DISCUSSION

4.1 Estimation Results

To examine the effect of capital adequacy requirement, liquidity requirement, bank size and asset quality requirement on the financial stability of the commercial banks in Tanzania, the study employed the panel data regression approach. Firstly, the study employed the generalized least square regression to examine the effect of capital adequacy requirement, liquidity requirement, bank size, asset quality requirement, and bank age on financial stability of the commercial banks that was proxied by Z-score. Table 1 presents the findings of this estimation.

The results show that prudential regulatory requirements have mixed effects on the financial stability of commercial banks in Tanzania. First, capital adequacy has a negative and significant influence on financial stability. This suggests that stricter capital adequacy requirements may constrain banks' flexibility and lending capacity, potentially weakening stability instead of strengthening it, as shown in Figure 1. While capital buffers are meant to absorb shocks, in the Tanzanian context they might be diverting resources away from productive use, which could limit banks' ability to grow and remain stable. These findings correspond with Sang (2021), who also found a significant relationship between capital adequacy and bank stability in Vietnam, and with Olawale (2024), who showed that capital adequacy affects resilience in Nigeria, though the direction of influence varied with economic volatility.

Second, the asset quality requirement has a positive but statistically insignificant effect. This means that while better asset quality could, in principle, improve stability by reducing default risks, the evidence here does not confirm a strong or consistent impact. It may indicate that asset quality rules are not effectively enforced, or that other factors overshadow their role in influencing stability. This result is consistent with Kuria et al. (2024), who highlighted that asset quality influences stability in Kenyan banks, and with Ariff and Shawtari (2019), who found asset quality to be an important factor in stability in Malaysia, though its impact depended heavily on enforcement and management practices.

Third, liquidity requirements have a negative and significant impact on stability. This implies that when banks are forced to hold too much liquid assets, they may sacrifice profitability and lending opportunities, as shown in Figure 2. Instead of acting as a cushion against shocks, liquidity rules might be limiting banks' earning power, making them less stable in the long run. This aligns with Snjawi and Essa (2021), who argued that liquidity management plays a dual role by reducing risks but potentially constraining performance, and with Ben Abdallah and Bahloul (2025), who showed that liquidity ratios can negatively affect profitability in Tunisian banks when not balanced with asset quality.



In contrast, bank-specific characteristics show strong positive effects. Larger banks tend to be more stable, likely because they enjoy economies of scale, diversified portfolios, and greater resilience to shocks. Similarly, older banks are more stable, which may reflect their accumulated experience, reputation, and stronger relationships with regulators and clients. These findings are supported by Mirichii (2023), who showed that larger SACCOs in Kenya demonstrated stronger stability through efficiency and diversification, and by GR (2025), who confirmed that size and asset quality significantly improve the financial performance of Indian public sector banks.

Overall, the findings highlight that not all prudential regulations contribute positively to stability. In Tanzania’s case, capital adequacy and liquidity requirements appear to impose costs that undermine stability, while bank size and experience emerge as the more important stabilizing forces. This conclusion resonates with Waqas and Bahrain (2019), who emphasized that prudential measures must be balanced with profitability to genuinely enhance stability, and with Kusi et al. (2023), who demonstrated that global prudential requirements post-financial crisis had mixed outcomes depending on the structure of local markets.

Table 1
Effects of CAR, AQR, LR, BSZ on Z-score

	Dep var: financial stability
Capital Adequacy Ratio	-0.0180*** (0.005)
Asset Quality Requirement	0.0057 (0.017)
Liquidity Requirement	-0.0858*** (0.0201)
Bank size	0.150*** (0.033)
Bank age (years)	0.0245** (0.010)
Constant	1.054* (0.589)
Observations	63
Number of banks	7

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

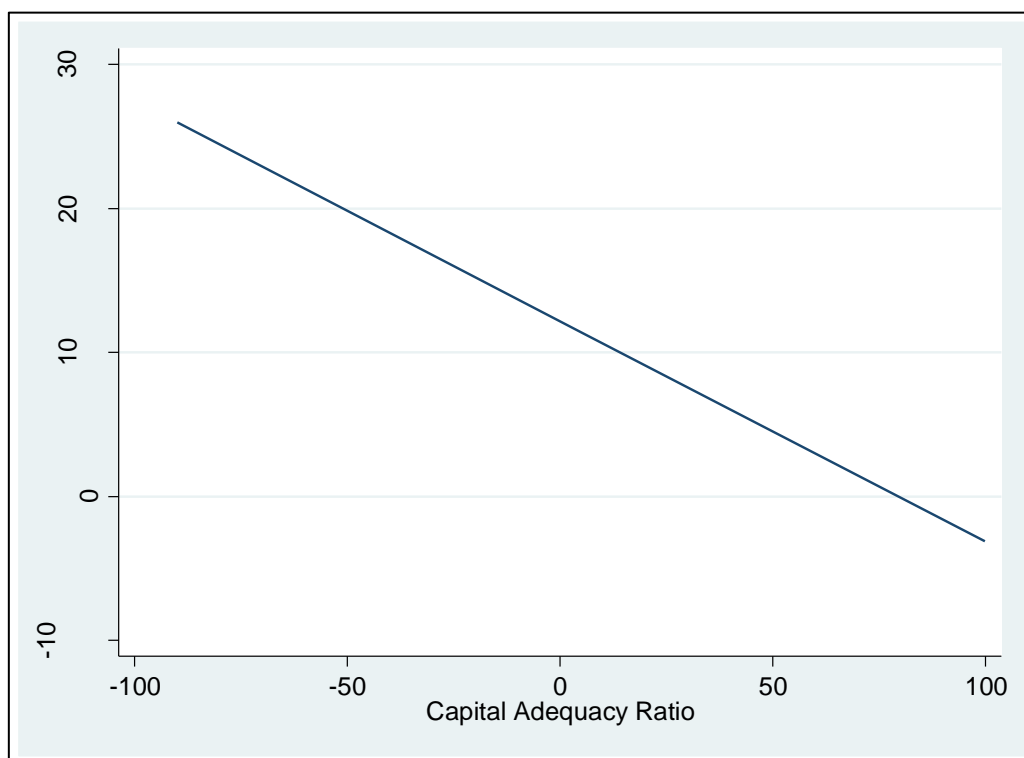


Figure 1
The Regression Line between the Capital Adequacy Ratio and Financial Stability

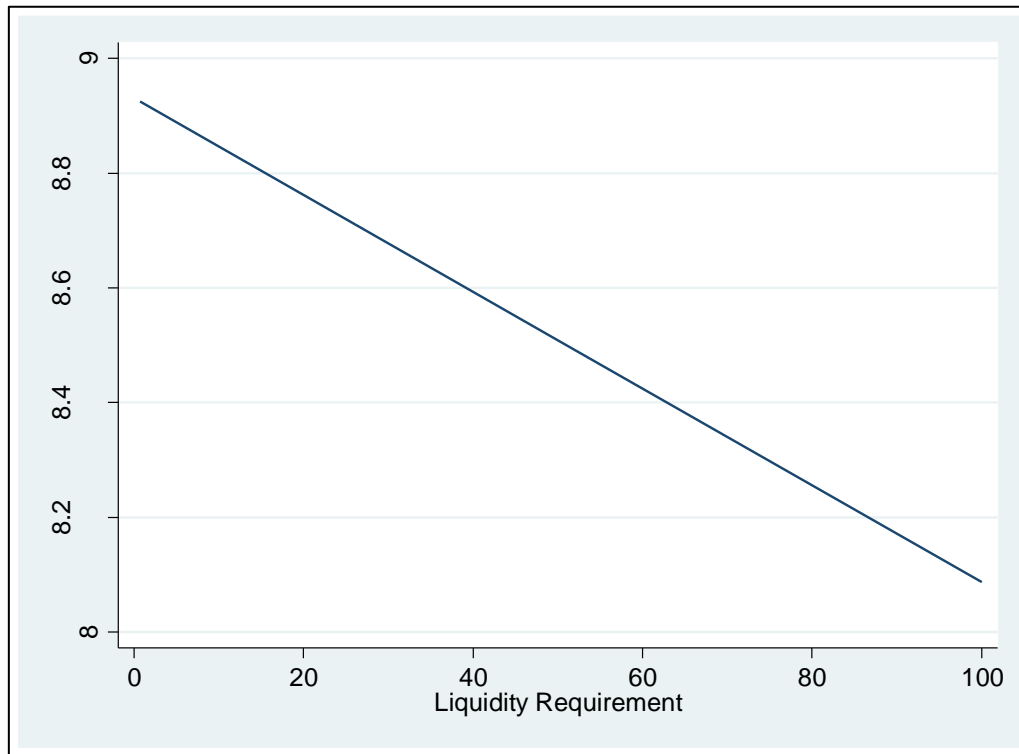


Figure 2
The Regression Line between the Liquidity Requirement and Financial Stability

4.2 Diagnostic Tests

4.2.1 Multicollinearity Test

Correlation matrix was employed to check for the presence of the multicollinearity among the study variables. The results are displayed in Tables 2 and 3. The results suggest that the correlation is not a problem

Table 2
Multicollinearity Test Results

	CAR	AQR	BS	LR
CAR	1			
AQR	-0.4344	1		
BS	0.2116	-0.5084	1	
LR	-0.3903	-0.0995	0.4115	1

Table 3

VIF test

Variable	VIF	1/VIF
AQR	1.38	0.724
BS	1.35	0.739
Bank age	1.04	0.964
Mean VIF	1.3	

4.2.2 Heteroscedasticity Test

Breusch Pagan test was employed to check for the heteroscedasticity for this study. The findings are presented in Table 4. Test: $Var(u) = 0$

Table 4
Heteroscedasticity Test Results

	Z-score model
chi2(01)	119.66
Prob > chi2	0.000



Findings show that Z-score model suffer from heteroscedasticity problem, since the p-values are significant, leading to reject the null hypothesis of constant variance. Hence the robust standard error was applied to account for the heteroscedasticity problem.

4.3 Discussion

4.3.1 Capital Adequacy Requirement

The results indicate that the capital adequacy requirement is negatively associated with financial stability. This outcome challenges the conventional wisdom that higher capital buffers automatically strengthen the banking system. In the Tanzanian context, the negative effect may be linked to the high cost of raising and maintaining capital, which reduces banks' flexibility and constrains lending. When banks are required to hold more capital, they may divert resources from income-generating activities, thereby weakening profitability and in turn reducing their overall stability. Another plausible explanation is that supervisory authorities may impose stricter capital requirements on banks already perceived as risky, creating a reverse-causality effect where higher capital coincides with weaker stability. This finding suggests that capital rules in Tanzania may not be fully aligned with the realities of the market and can even produce procyclical effects (Sang, 2021; Olawale, 2024; Waqas & Bahrain, 2019).

4.3.2 Liquidity Requirement

Liquidity requirements also show a negative and significant effect on financial stability. This indicates that forcing banks to hold large portions of their assets in liquid form may have unintended consequences. In Tanzania, financial markets are relatively shallow, and the instruments used to meet liquidity requirements often yield low returns. As a result, banks face an opportunity cost: they forgo more profitable lending activities in order to comply with regulatory liquidity buffers. This weakens profitability and diminishes resilience, as stable earnings are a critical pillar of financial stability. Instead of acting as a safeguard, liquidity requirements appear to reduce stability by eroding banks' earning capacity (Snjawi & Essa, 2021; Ben Abdallah & Bahloul, 2025; Chioma et al., 2021).

4.3.3 Asset Quality Requirement

The asset quality requirement has a positive but statistically insignificant effect on financial stability. This means that, while improving the quality of assets should logically enhance stability by reducing credit risk, the actual impact in this case is weak. Several factors may explain this outcome. First, most listed banks may already maintain relatively similar levels of asset quality, reducing variation in the data. Second, improvements in asset quality often take time to materialize in stability indicators, meaning the effects may not appear immediately. Third, some banks may comply superficially with asset quality standards, restructuring loans or adjusting classifications without addressing the underlying credit risk. This weak relationship suggests that enforcement and monitoring of asset quality requirements may need to be strengthened (Kuria et al., 2024; Ariff & Shawtari, 2019).

4.3.4 Bank Size and Bank Age

Unlike regulatory requirements, bank-specific characteristics such as size and age are strongly associated with stability. Larger banks demonstrate higher stability, which can be attributed to diversification of operations, broader customer bases, stronger funding access, and greater economies of scale. Older banks also appear more stable, reflecting accumulated experience, established reputations, and more mature risk-management practices. These findings highlight that organizational structure and history play an important role in ensuring resilience, sometimes even more than regulatory thresholds (Mirichii 2023; GR, 2025).

4.3.5 Broader Interpretation

The overall findings challenge the assumption that prudential regulations uniformly promote stability. Instead, they show that in Tanzania, capital and liquidity requirements may undermine stability by constraining profitability and limiting banks' ability to manage risks effectively. On the other hand, structural factors such as size and experience act as natural stabilizers. This context-sensitive outcome suggests that prudential regulation cannot be imported wholesale from international standards but must be adapted to the specific characteristics of the local banking sector.

The study demonstrates that regulatory requirements, while well-intentioned, may not always yield the desired outcomes in emerging markets like Tanzania. Stability is shaped not only by compliance with prudential ratios but also by profitability, market structure, and institutional capacity. Effective regulation therefore requires a balanced approach that safeguards resilience without undermining banks' ability to generate sustainable returns (Kusi et al., 2023).



V. CONCLUSION & RECOMMENDATIONS

5.1 Conclusion

This study set out to examine the influence of prudential regulatory requirements on the financial stability of listed commercial banks in Tanzania. The findings reveal that not all prudential rules contribute positively to stability. Both capital adequacy and liquidity requirements show significant negative effects, suggesting that when compliance is costly and markets are shallow, these requirements may erode profitability and reduce stability instead of reinforcing it. Asset quality requirements move in the expected positive direction but lack statistical significance, pointing to weak enforcement or delayed effects. In contrast, bank-specific factors, particularly size and age, play a strong and consistent role in strengthening financial stability, reflecting the importance of organizational capacity, experience, and scale in managing risks.

The broader implication is that stability in the Tanzanian banking sector cannot be guaranteed by rigid adoption of international prudential standards alone. Regulations must be carefully calibrated to local market realities, ensuring that compliance does not undermine banks' earnings and resilience. Strengthening asset quality supervision, deepening financial markets, and promoting institutional growth and maturity are likely to yield better outcomes. Ultimately, financial stability in Tanzania depends on striking the right balance between regulatory safeguards and the structural strengths of banks themselves, ensuring that prudential measures complement rather than constrain the sector's long-term resilience.

5.2 Recommendations

The results highlight the need for prudential regulation in Tanzania to be more context-specific and proportionate. Capital adequacy and liquidity requirements should be carefully recalibrated to avoid unintended costs that weaken bank stability. Regulators could adopt more flexible frameworks such as phased or countercyclical buffers, which rise during good times and ease during downturns, preventing procyclical effects. At the same time, strengthening enforcement around asset quality requirements is crucial to ensure that improvements in reported loan performance reflect genuine reductions in credit risk rather than cosmetic adjustments. By focusing on the quality of implementation rather than only the level of compliance, supervisors can help ensure that regulations genuinely enhance stability.

Beyond adjusting rules, broader system-level reforms are also essential. Deepening interbank and securities markets would reduce the opportunity cost of holding liquidity, turning mandatory buffers into genuine safeguards. Supporting banks to grow and consolidate can enhance the positive effects of size and experience, while promoting stronger governance and risk management cultures. Regulators should therefore embrace a balanced approach: one that maintains prudential safeguards but also nurtures profitability, growth, and institutional learning. Such a strategy would align regulation with the structural realities of the Tanzanian banking sector and ensure that prudential measures contribute to long-term financial stability rather than constraining it.

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