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Assessing the Impact of Resource Allocation Strategies on the Performance of Iran's Banking System: An Islamic Banking Perspective

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Highlights

- ***The study explores the impact of resource allocation strategies (the ratio of exchange to partnership contracts) on Islamic bank performance.***
- ***An ARDL model analyzes data from Iran's banking system (1986–2023).***
- ***The results show Increasing the ratio of exchange to partnership contracts enhances banking performance***

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Abstract

This study investigates the impact of allocation of banking resources based on exchange contracts and partnership contracts on the performance of Islamic banks. Given the distinct nature of the Islamic contracts, resource allocation Strategies play a pivotal role in shaping bank profitability. This research aims to assess how these allocation strategies influence the performance of Islamic banking systems. Using annual data from the Iranian banking system (1986–2023), this study employs an ARDL model to analyze the relationships between resource allocation policies and bank performance in short and long-run. Empirical findings reveal that a one-unit increase in the ratio of exchange to partnership contracts is associated with a 2.9-unit improvement in banking performance. This suggests that reallocating financial resources toward exchange contracts contributes positively to the efficiency of banks. The underlying rationale may lie in the predetermined and fixed return structure of exchange contracts, which typically entail lower risk compared to partnership-based contracts governed by the profit-and-loss sharing framework and are more vulnerable to fluctuations in macroeconomic conditions. This result is further corroborated by the observed inverse relationship between economic growth and banking performance in long run. Additionally, the analysis indicates that inflation exerts a detrimental effect on banking performance, whereas an increase in the exchange rate appears to improve it. Consequently, the results show that an increase in the ratio of exchange to partnership contracts can improve the overall performance of banks, highlighting the practical advantages of more stable, return-predictable financing instruments under certain economic conditions.

1. Introduction

Allocation of resources in Islamic banking has features that fundamentally differentiate it from conventional banking. These differences have caused the economic effects of resource allocation in Islamic banking to be different from

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conventional banking. One of the important features of Islamic banking is that resources are allocated mainly in the form of Qarz al-Hasan contracts, partnership contracts and exchange contracts. Usually, Qarz al-Hasan contracts are classified as non-profit contracts, and exchange and partnership contracts are classified as for-profit contracts. Since the profit contracts are divided into two categories of partnership and exchange, banks have the possibility of policymaking in allocating their resources between these two categories of contracts. As a strategic instrument, the allocation mechanism of bank resources within Islamic banking serves as a significant policy tool, aligning financial distribution with Sharia-compliant principles and contributing to economic stability (Asadian & Kashian, 2024).

The most important difference between exchange and partnership contracts is in the method of risk sharing and their type of return. In partnership contracts, banks share in the profit and loss of the borrower, and therefore bears a high risk. while in exchange contracts, the bank receives a fixed rate from the customer, thereby bearing less risk. Naturally, the approach to allocating resources in Islamic banking greatly influences the economic performance of banks. Meanwhile, some contracts have a specific economic performance and if resources are allocated by that contract, it will be affected by that, for example, Mudarabah loan, which is a type of partnership contract, is only used in the field of trade. when banks allocate resources in the form of Mudarabah, the bank enjoys the profit of the trade. In the same way, Musakat and Muzareh contracts, which are a type of partnership contract, are dedicated to agriculture. Therefore, whether the resources are allocated in the form of partnership contracts or in the form of exchange contracts, it affects the performance of banks (Meysami & Mousavian, 2019).

According to the theoretical framework, the performance of banking institutions is profoundly influenced by the mechanisms employed for resource allocation, highlighting the necessity of examining the relationship between targeted variable. The research seeks to address the critical question: To what extent does the shift from partnership-based contracts to exchange-based contracts in Islamic banking influence the economic performance of banks in Iran? While previous studies have explored the implications of Islamic banking contracts on macroeconomic variables, the literature remains sparse regarding their impact on internal banking performance. For instance, Kashian (2024) investigated the effect of expanding partnership contracts on economic inequality in Iran, and Asadian & Kashian (2024) demonstrated that such structural transitions could enhance banking stability. Other works have assessed the relationship with economic growth and inflation. However, the specific effects of contract transitions on bank-level performance metrics remain largely unexamined. This research aims to fill this critical gap by analyzing how the structural composition of Islamic contracts shapes banking performance, positioning this inquiry within the broader discourse of Islamic financial stability and economic resilience.

The choice of Iran as the case study is due to the fact that Iran is one of the few countries where Islamic banking is fully implemented and all banking processes are based on Islamic contracts. Naturally, the effects of this type of banking on macroeconomic variables are clearer in Iran than in other countries where Islamic banking is a part of their banking system.

Based on this, the present research will first present the theoretical foundations, then the research method will be examined, and in the fourth part, the results of the study will be presented. The fifth section presents a summary and emphasizes policy suggestions.

2. Theoretical Foundations

2.1 Islamic Bank performance

Evaluating the performance of Islamic banking holds significant importance, given the wide range of stakeholders involved in the banking sector, including investors, government authorities, communities, and affiliated institutions. A strong performance in Islamic banking is anticipated to draw the interest of investors, as it is perceived to yield favorable returns. Furthermore, policymakers are particularly attentive to the outcomes of Islamic banking operations, acknowledging its substantial role in contributing to national economic growth (Insani & Muflih, 2019).

The performance of a country's banking system can be evaluated from several aspects, one of the most important is the aspect of macroeconomic variables. Among macroeconomic variables, exchange rate, monetary policy and economic growth are the most important variables. However, there are other effective factors in Islamic banking that differentiate it from conventional banking. The most important of these factors is the policy of the banking system in allocating resources based on different Islamic instrument. The type of policy that banks use in this regard can have an important impact on the banking system performance.

2.2 Contracts in Islamic Banking

In the context of Islamic economics, some variables contribute to the performance of banking system with the method of fund allocation being one of the most critical. Islamic banking adheres strictly to the prohibition of interest (usury), as stipulated in the Quran (Surah Al-Baqarah, verse 278). As a result, all financial and banking transactions are structured to eliminate any form of interest-based dealings. Generally, Islamic banking contracts can be categorized into three main groups, which encompass:

1) Exchange Contracts – predetermined profit in accordance with Sharia principles.
2) Partnership Contracts Profit and loss sharing agreements.
3) Qarz al-Hasan – Interest-free benevolent loans.

Islamic financial contracts can be divided into two categories: non-profit contracts and profit-oriented contracts. Non-profit contracts, such as waqf

(endowment) and Qard al-Hasan (benevolent loan), are primarily used for charitable purposes and the promotion of welfare activities. In contrast, profit-oriented contracts are employed in economic and commercial activities, as well as in financing the purchase of goods, and can be structured with either fixed or variable returns (Asadian & Kashian, 2024).

2.2.1 Exchange Contracts

In situations where borrowers or financial service providers seek fixed-rate, low-risk contracts, exchange contracts are utilized. According to this contract, the bank provides a portion of the capital required for purchasing goods or investing in a specific project and, in return for its participation in the economic activity, receives a share of the profit. Unlike conventional investments, the bank's profit is predetermined at the time of contract execution, regardless of the venture's actual performance or market fluctuations (Mousavian, 2012, p. 33). Notable types of exchange contracts include Murabaha and Leasing.

2.2.2 Partnership Contracts

These contracts involve agreements where an agent provides part of the necessary resources for carrying out an economic activity, whether in trade, or services. The profits are distributed in accordance with the terms outlined in the original contract. Key features of these contracts include profit and loss sharing, profit variability, and the requirement for continuous monitoring and oversight. Within Islamic banking, several forms of partnership contracts are utilized, including Mudarabah (Kashian, 2025)

2.3 Transition Policy

An analysis of the definitions and characteristics of exchange and partnership contracts reveals a fundamental distinction: exchange contracts are associated with fixed returns and low-risk, whereas partnership contracts are linked to variable profits and high-risk. However, the key appeal of partnership contracts lies in their potential for higher returns, as banks are willing to take on greater risk. This trade-off allows banks to tailor their policies according to their risk tolerance—opting for partnership contracts to pursue higher profits or increasing bill financing through exchange contracts to secure stable returns with lower risk exposure. A critical indicator of a bank's risk preference is exchange to partnership contracts ratio. Increasing in ratio suggests a more risk-averse approach, while a lower ratio indicates a greater willingness to embrace risk (Asadian & Kashian, 2024).

Another key differentiating factor between these two contract types is the level of supervision required by the bank. As exchange contracts involve fixed profits, banks have limited control over the use of resources. In contrast, partnership contracts, due to their variable profit structure, necessitate ongoing monitoring and supervision. Consequently, the allocation of resources through partnership contracts incurs supervision costs, which may decrease the efficiency

of the banking system. The primary advantage of partnership contracts lies in the potential for higher returns by accepting greater risks.

2.4 Bank Performance and Macroeconomics Variable

Macroeconomic factors significantly influence the performance of banks (Lyimo, 2022; Mbaluka et al., 2023). These external variables, beyond a bank's direct control, shape the overall economic health and impact bank operations in various ways. Here's a breakdown of how key macroeconomic variables can affect banks (Lyimo, 2022; Mbaluka et al., 2023). Since transition policy is a macro policy by banking system, we use the macroeconomic variables as control variables:

- **GDP Growth:** A growing GDP is generally associated with positive bank performance (Lyimo, 2022). Economic expansion leads to increased demand for loans from businesses and individuals looking to invest and grow. This translates to higher loan demand and potentially greater interest income for banks (Mbaluka et al., 2023).
- **Inflation:** Inflation can have a two-sided impact on banks (Lyimo, 2022). Moderate inflation can increase nominal interest rates and improve profitability. Nevertheless, elevated inflation levels can diminish the real value of a bank's assets and inhibit lending activities due to heightened economic uncertainty (Lyimo, 2022).
- **Exchange Rate:** The impact of exchange rates on bank performance can be more nuanced and depend on the bank's specific operations (Mbaluka et al., 2023). A strong domestic currency can make foreign borrowing cheaper but also reduce the competitiveness of exports, potentially affecting loan demand from export-oriented businesses. Conversely, a weaker domestic currency can make exports more competitive but increase the cost of foreign borrowing (Mbaluka et al., 2023).

The influence of these variables may differ based on contextual factors and the effectiveness of a bank's risk management strategies (Lyimo, 2022).

2.5 Literature review

A substantial body of literature has been dedicated to assessing the performance of Islamic banks, both independently and in comparison, with conventional banking institutions. Beck et al. (2013) undertook an extensive study involving 510 banks—88 of which were Islamic—across 22 countries. Their analysis revealed that although Islamic banks are generally better capitalized, they exhibit lower cost efficiency relative to their conventional counterparts.

Likewise, Abedifar et al (2013) answer the question of whether there are any differences between conventional and Islamic banks in terms of insolvency risk or the application of higher fees for Sharia-compliant financial products. The answer is no. Furthermore, Johnes et al. (2014) reported that Islamic banks are likely to demonstrate lower efficiency levels, attributing this gap to the additional compliance obligations associated with Sharia law. However, they also

recognized that the expertise and managerial capabilities within Islamic banks play a crucial role in alleviating these inefficiencies (Alam & Rizvi, 2017).

In another study, Avani et al (2021) aim to evaluate the impact of the Islamic banking penetration rate in each country on that country's banking stability. Drawing on data from seven countries with a substantial presence of Islamic banking and eight countries dominated by conventional banking systems (2008-2018), the researchers applied regression model with panel data. Their findings indicated that the expansion and greater integration of Islamic banking contributed positively to the banking sector stability.

Butt et al. (2022) proposed that financial risks might lead to reputational risks, which in turn could threaten the performance of banks. Using 24 conventional and Islamic banks (2007 to 2017) Their findings indicate that reputational risk had no significant mediating role for Islamic banks but serves as a good mediator in the linkage between performance conventional financial institutions and financial risks.

Asadian and Kashian (2024) explored how "transition policies" impact the stability of Islamic banks. Using quarterly data from 2014 to 2020 across four Islamic countries with substantial resource allocation through Islamic contracts, they applied regression model. Their results revealed that such policies can affect banking stability.

Finally, Kashian (2025) analyzed how resource allocation policies in Islamic banking, specifically the shift from exchange contracts to partnership contracts, influence economic inequality in Iran. Utilizing data from 1365 to 1400 H.SH and employing the Autoregressive Distributed Lag (ARDL) method, the study found that a transition towards partnership contracts exacerbates economic inequality. For each 1-unit increase in the ratio, the Gini coefficient increased by 0.03 units. This increase in inequality was particularly pronounced in Iran's inflationary context, where inflation consistently outpaced bank interest rates, intensifying economic disparities

Among related studies, Shahabadi & Samari (2013) found that higher levels of economic freedom positively influence bank performance through improved institutional quality and property rights. Similarly, Taheri Haftasiabi et al. (2023), using machine learning methods, emphasized the importance of bank credit indicators—particularly the debt service ratio—in predicting financial crises, highlighting how the structure of credit allocation can affect financial stability.

Although prior research has addressed the effects of resource allocation on aspects such as banking stability and economic inequality, limited scholarly attention has been devoted to examining its direct impact on the overall performance of banks. Considering the distinctive nature of Iran's fully Sharia-compliant banking system, where the structure and form of financial contracts play a pivotal role, resource allocation strategies are likely to exert profound effects on banking system performance. Nevertheless, the existing body of literature predominantly emphasizes broad comparisons between Islamic and conventional banks, without systematically investigating how variations in

resource allocation influence bank performance. This study aims to bridge this critical gap by providing a rigorous empirical evaluation of the relationship between resource allocation strategies and the performance outcomes of Iran's banking sector, thereby contributing to the advancement of knowledge in Islamic banking and informing the development of more effective financial policies and management practices.

3. Research methodology

The third section provides some description of the data utilized in this study, along with the methodological framework applied to analyze the research objectives.

3.1 Data

The data collected spans the period from 1988 to 2023, based on the availability of relevant statistics. The indicators used for the analysis include:

BP= ROA[1] of Banking System
GGDP= Growth of Gross Domestic Product
MTOM= Ratio of Exchange Contracts to Partnership Contracts
Inf= inflation rate
EX= Unofficial exchange rate

3.2 Specification of Model and method

The model used in this research is defined as follows:

$$BP_t = \alpha + \beta_1 GGDP_t + \beta_2 MTOM_t + \beta_3 Inf_t + \beta_4 EX_t + u_t \quad (1)$$

The analytical approach employed in this study is the ARDL[2] model. The ARDL method is well-suited for examining time series data that may be non-stationary or possess different integration orders (Pesaran & Shin, 1995). By incorporating a sufficient number of lags, the model effectively captures the underlying data dynamics (Shrestha & Bhatta, 2018). To validate the reliability and accuracy of the model's estimates, it is essential to assess its performance through goodness-of-fit measures and perform comprehensive diagnostic tests.

The ARDL model have some advantages over other econometric methods, especially when handling time series or panel data with a mix of (I(0)) and (I(1)) variables. One of its primary strengths is the ability to give analysis both on short-run dynamics and long-run. This enables researchers to differentiate between immediate, temporary effects and more enduring, structural impacts. Unlike other models like VAR or VECM, which require all variables to be either stationary or co-integrated, the ARDL model is more flexible, requiring that no variable is integrated of order two (I(2)). Additionally, ARDL performs well with smaller sample sizes and supports some tests to examine relationships between variables

[1] Ratio of return on Asset
[2] Autoregressive Distributed Lag

in long-run, thereby improving the robustness and reliability of the empirical results (Pesaran et al, 2001).

3.3 Diagnostics tests and Goodness of fit

3.3.1 Goodness of fit

A preliminary evaluation of regression coefficient robustness involves assessing the model's fit, checking for serial correlation in residuals, and determining overall model significance. Key tests include the R-squared (R^2), indicating fit strength, and the Durbin-Watson (DW) statistic, used to detect autocorrelation, with a value near 2 suggesting no autocorrelation (Shrestha & Bhatta, 2018).

3.3.2 Stationarity of variables:

The assessment of stationarity is a critical step in ARDL model, and is typically achieved through statistical procedures known as unit root tests. Several methodologies exist for this purpose each with its own strengths and weaknesses (Shrestha & Bhatta, 2018). In this research the Phillips-Perron test is employed in due to its established recognition and prevalent use within the field. This choice reflects the desire to utilize a well-documented and widely accepted approach for robustly assessing the stationarity of the time series under investigation.

3.3.3 Diagnostics tests:

Diagnostic tests in econometric modeling, such as lag structure, coefficient, and residual diagnostics, are essential for model validation. Residual diagnostics are particularly critical, as regression models aim to minimize errors. For a valid model, error terms must exhibit white noise properties (i.i.d.). Key methods include the Lagrange Multiplier (LM) test, correlograms, and heteroskedasticity tests. Stability diagnostics ensure model parameters remain consistent across sub-samples, confirming robustness over time.

4. Results and Discussion

4.1 Descriptive analysis

Firstly, the characteristics of the data used in this research are investigated. As the data in the table 1 shows, the 5 variables used in this research are banking performance, economic growth, inflation, the ratio of cooperative to exchange contracts and the logarithm of the exchange rate. The data of the research were from 1986 to 2023, and as the data in Table 1 shows includes 36 years.

The main research variable is the ratio of partnership contracts to exchange contracts. As the results of the descriptive statistics indicate, the mean of this index in Iran was 0.68, and this indicates that during the 36 years under study, banks were more inclined towards exchange contracts. However, in some years, this index reached 1.2, which indicated the change in banks' preferences in resource allocation, and in some years, the index reached 0.28, which indicated the reluctance of banks to grant cooperative facilities.

Table1. Descriptive analysis

	BP	GR	INF	LNEX	MTOM
Mean	2.304398409	2.803157895	22.88773446	9.310685166	1.578626796
Minimum	0.9179345	-9.78	7.245426	6.609349	0.6527418
Maximum	6.737226486	13.59	49.65598679	13.03898144	3.225810528
Median	1.669824481	2.705	18.22156048	9.0930505	1.591995478
Std. Dev.	1.574566431	4.7211869	12.06381707	1.716937695	0.752112962
Skewness	1.807633001	-0.11185155	0.843144068	0.498739344	0.548161591
Kurtosis	4.969083576	3.544825253	2.729819869	2.589317625	2.303452922

***Source**: Research Finding*

4.2 Diagnostic test

To prevent spurious regression, ensuring variable stationarity is essential. This study applies the ADF[1] test for this purpose (Table 2). Given the mix of I(0) and I(1) variables, the ARDL approach is appropriate.

Table 1. Unit root test result

Variable	In level		First Difference		Stationarity
	Statistic	Prob	Statistic	Prob	
MTOM	-2.123574	0.23	-6.198093	0.0000	I(1)
LnEX	1.233176	0.99	-4.96376	0.0003	I(1)
INF	-2.187598	0.21	-5.893032	0.0000	I(1)
BP	-3.818960	0.0061	-	-	I(0)
Gr	-4.904401	0.0003	-	-	I(0)

***Source**: Research Finding*

The Phillips-Perron test reveals that some variables are non-stationary at the level but achieve stationarity after first differencing, while others are stationary at the level. Therefore, the ARDL model is suitable for further analysis, provided that diagnostic tests confirm its optimality.

The next step in the modeling process is determining the optimal lag structure for the variables included. Due to the limited sample size, the optimal number of lags was identified using the Schwartz-Bayesian criterion (SBC), a well-established approach for selecting the appropriate lag length. The model is then estimated using this chosen lag structure. Following Schwartz's criterion for determining optimal lag intervals, the model will be specified and estimated accordingly:

Selected Model: ARDL(5, 4, 4, 4, 4)

In this Model, bank performance with 2 lags, economic growth with 4 lags, inflation with 3 breaks, exchange rate and ratio of contracts without any lags are chosen base on Schwartz-Bayesian criterion.

[1] Augmented Dickey-Fuller

Table 2. Goodness of fit and autocorrelation

R^2	0.97
DW stat	2.24
Adjusted R^2	0.68

***Source**: Research Finding*

The Durbin-Watson (DW) statistic confirms the absence of autocorrelation, while R^2 and Adjusted R^2 values above 75% indicate a good fit. The Breusch-Godfrey LM Test also shows no evidence of serial autocorrelation at a satisfactory confidence level (table4).

Table 3. BG LM Test

F-statistic	1.86326	Prob. F(2,16)	0.5305
Obs*R-squared	31.4375	Prob. Chi-Square(2)	0.3941

***Source**: Research Finding*

The Jarque-Bera (JB) test results show that the null hypothesis of normality is not rejected at a satisfactory confidence level (Figure1).

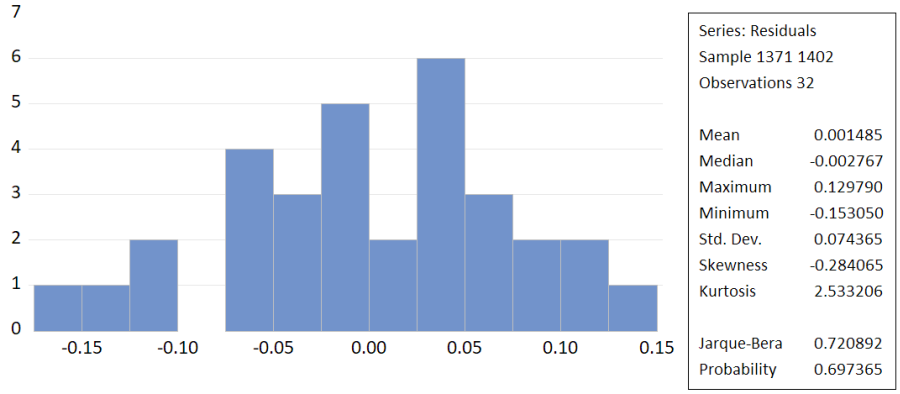

Figure1. Normality test
***Source**: Research Finding*

The Breusch-Pagan-Godfrey test results indicate that the null hypothesis of homoscedasticity is not rejected at a satisfactory confidence level (table5).

Table 5. Heteroskedasticity Test

F-statistic	1.849029	Prob. F(13,18)	0.1125
Obs*R-squared	18.29791	Prob. Chi-Square(13)	0.1465
Scaled explained SS	4.80401	Prob. Chi-Square(13)	0.9793

***Source**: Research Finding*

ECM Regression model shows that CointEq(-1) Coefficient is $0 < C < 1$ with the prob of 0.0000, so the model has convergency and the result of model are reliable.

Table6. ECM Regression

	Coeff	Std. Er	t-Stat	Pr.
CointEq(-1)*	-0.4901	0.094821	-7.03385	0.001

***Source**: Research Finding*

The F-Bounds Test confirms the model's significance, rejecting the null hypothesis of no long-term relationship.

Table 7. F-Bounds Test

F-statistic	Significant	Critical value	
		Lower **B**ounds	Upper Bounds
4.7237	10%	1.9	3.01
	5%	2.26	3.48
	2.5%	2.62	3.90
	1%	3.07	4.44

***Source**: Research Finding*

4.3 Long run Estimation Results

After ensuring the establishment of the necessary conditions for the correct implementation of a model, in this section the results of the estimation of parameters are discussed. Figure 1 shows the long-term estimation results of model parameters based on ARDL method.

Table 8. The estimation results in long run

Var	Coef	Std. Er	t-Stat	Pr.
MTOM	2.902343	0.568276	5.107277	0.0363
LNEX	0.658134	0.084292	7.807813	0.016
GR	-0.515586	0.117995	-4.369556	0.0486
INF	-0.33235	0.058346	-5.696214	0.0295

***Source**: Research Finding*

The results from the long-run ARDL estimation reveal several key insights into the dynamics influencing banking performance (BP). Specifically, the variable MTOM, representing the ratio of exchange to partnership contracts, shows a positive and statistically significant coefficient of 2.90. This indicates that increasing the proportion of exchange contracts within banking resource allocation positively impacts banking performance. The less monitoring cost and lower risk associated with exchange contracts compared to partnership-based (PLS) contracts likely contribute to this positive effect.

Interestingly, the coefficient for economic growth (GR) is negative and significant, suggesting that a one-unit increase in economic growth leads to a 0.52-unit decline in banking performance. This counterintuitive finding may reflect structural inefficiencies or delays in the transmission of economic growth benefits to the banking sector. While the short-run impact of this variable tends to be positive, indicating that initial lags may temporarily boost banking performance, its long-run effect appears detrimental.

Regarding control variables, inflation (INF) has a negative and significant effect on banking performance. A one-unit increase in the inflation rate corresponds to decreasing in banking performance approximately by 0.33 units, highlighting the adverse impact of inflationary pressures. Conversely, the exchange rate (LNEX) exhibits a positive and significant effect. This suggests that fluctuations in the exchange rate may enhance banking performance, potentially by improving the competitiveness and profitability of the banking sector.

4.4 Discussion

As discussed in the preceding sections, Islamic banks primarily allocate their resources through two major financing instruments: partnership contracts and exchange contracts. Exchange-based contracts offer fixed returns, carry lower risk, and typically require minimal monitoring. In contrast, partnership-based contracts operate under a profit-and-loss sharing (PLS) mechanism, are inherently riskier, and demand continuous oversight from the banks. The allocation policy between these two modes of financing plays a critical role in the overall performance of Islamic banks.

The central hypothesis of this study—that the ratio of exchange to partnership contracts significantly affects banking performance—has been empirically confirmed. As shown in Table 8, the MTOM variable coefficient is statistically significant and positive (2.90), so 1-unit increase in the ratio of MTOM enhances the banking performance index by approximately 2.9 units. Thus, the relationship between the method of resource allocation and banking performance is positive and significant.

These findings suggest that reallocating resources toward exchange contracts has a favorable effect on the performance of Islamic banks. The fixed return structure and lower monitoring requirements make exchange contracts more predictable and manageable under economic uncertainty. While partnership contracts may offer higher potential returns, their vulnerability to market fluctuations and the costs associated with risk-sharing and monitoring can adversely affect performance, particularly in volatile economic environments.

The analysis also confirms a significant and indirect relationship between banking performance and economic growth, with each unit increase in economic growth reducing performance by approximately 0.515 units. This countercyclical pattern may reflect inefficiencies in channeling growth into financial stability or the delayed impact of macroeconomic improvements on bank performance.

Furthermore, inflation negatively affects banking performance, reducing it by 0.33 units for each additional unit increase in the inflation rate, possibly due to increased uncertainty, higher operational costs, and the erosion of real returns. In contrast, a direct and significant relationship is observed between the exchange rate (LNEX) and banking performance, where a 1-unit increase in the LNEX leads to an improvement of 0.658 units. This may be attributed to the positive effects of currency depreciation on foreign exchange earnings and asset revaluation in foreign currency terms.

In summary, the study highlights the strategic importance of favoring exchange-based financing in enhancing banking performance, particularly under conditions of macroeconomic instability. However, the findings also underscore the need for balanced resource allocation and robust risk management frameworks to ensure sustainable performance in Islamic banking.

4.5 Short Run Estimation Results

The short-run dynamics of banking performance (BP), influenced by key macroeconomic and policy variables, are assessed using the estimated ECM derived from the selected ARDL specification. The results, presented in Table 9, show that the coefficient of the EC term (CointEq(-1)) is -0.4975, statistically significant (p-value = 0.0138). This indicates a long-term equilibrium relationship among the variables. It also implies that approximately 49.75% of any short-term deviation from the long-term equilibrium is corrected each period, reflecting a relatively rapid adjustment process in the banking sector.

In the short run, lagged changes in banking performance show a significant and dynamic pattern. The coefficients of lagged dependent variables (D(BP(-1)) to D(BP(-5))) are mostly significant and alternating in sign, indicating complex temporal interdependencies. For instance, the third lag (D(BP(-3))) has the highest absolute impact with a coefficient of -1.16 and a highly significant p-value (0.0129), reflecting strong inertia and correction dynamics in the banking system.

Regarding the resource allocation policy variable (MTOM), its current change (D(MTOM)) has a direct effect on banking performance (coefficient: 0.309; p-value = 0.0812), while its first and subsequent lags exhibit negative and significant effects, particularly in the third (coefficient: -0.629; p-value = 0.0215) and fourth lags (coefficient: -0.610; p-value = 0.0186). This pattern suggests that although increasing the MTOM may initially enhance performance, delayed effects may introduce risks and monitoring burdens that dampen performance in later periods.

As for exchange rate (LNEX), the results demonstrate mixed effects. The first lag (D(LNEX(-1))) has a direct and moderately significant impact (coefficient: 1.015, while longer lags turn negative, with the fourth lag (D(LNEX(-4))) showing a strong negative effect (coefficient: -2.304; p-value = 0.0166). These findings reflect the trade-offs between short-term and long-term with respect to exchange rate.

Table 9. Short Run Estimation

Variable	Coeff	Std. Er	t-Stat	Pr*
D (BP(-1))	-0.395531	0.133931	-2.953253	0.0981
D (BP(-2))	-0.882462	0.16908	-5.219205	0.0348
D (BP(-3))	-1.161768	0.133167	-8.72417	0.0129
D (BP(-4))	-0.146082	0.078553	-1.859664	0.204
D (BP(-5))	0.412391	0.082052	5.025995	0.0374
D(MTOM)	0.309479	0.094009	3.292015	0.0812
D(MTOM(-1))	-0.421284	0.10611	-3.97026	0.058
D(MTOM(-2))	-0.124549	0.083334	-1.494577	0.2736
D(MTOM(-3))	-0.629106	0.093702	-6.713938	0.0215
D(MTOM(-4))	-0.609559	0.084312	-7.229799	0.0186
D(LNEX)	-0.112191	0.229723	-0.488375	0.6736
D(LNEX(-1))	1.014513	0.328132	3.091783	0.0906
D(LNEX(-2))	0.73364	0.302717	2.423516	0.1363
D(LNEX(-3))	-1.417915	0.332081	-4.269788	0.0507
D(LNEX(-4))	-2.30399	0.30053	-7.666423	0.0166
D(GR)	-0.025589	0.017938	-1.426574	0.2898
D (GR(-1))	0.2237	0.035362	6.326057	0.0241
D (GR(-2))	0.263736	0.037264	7.07752	0.0194
D (GR(-3))	0.141622	0.024497	5.781193	0.0286
D (GR(-4))	0.039273	0.015328	2.562226	0.1245
D (INF)	-0.069348	0.011224	-6.178301	0.0252
D (INF(-1))	0.059819	0.009758	6.130393	0.0256
D (INF(-2))	0.061302	0.011922	5.14213	0.0358
D (INF(-3))	0.085967	0.01245	6.904713	0.0203
D (INF(-4))	0.070595	0.007911	8.923929	0.0123
CointEq(-1)*	-0.497535	0.059107	-8.417585	0.0138

***Source**: Research Finding*

The influence of economic growth (GR) is more consistently positive. Although the current value of GR has no significant impact, its lagged values—particularly the first three lags—exhibit strong positive and statistically significant coefficients (e.g., D(GR(-2)) = 0.264, p-value = 0.0194). This confirms that economic expansion, with a lag, improves banking performance by enhancing credit quality and investment opportunities in short term, in contrast in the long term the result is conversely.

In the case of inflation (INF), the immediate impact is negative and significant (D(INF) = -0.069; p-value = 0.0252), suggesting that inflation shocks initially harm banking performance. However, this effect reverses over time: all lagged inflation variables (from one to four lags) are positively significant, with

the fourth lag (coefficient: 0.071; p-value = 0.0123) exerting the strongest effect. This delayed positive response likely reflects banks' adaptive pricing and interest margin adjustments to inflationary conditions.

4.6 Stability of Model

To assess the model's stability and verify the absence of structural instability, the CUSUM and CUSUM of Squares tests were applied. The results shown in Figure 2 indicate that the model remains stable, as the hypothesis of structural failure is rejected. This suggests that the model's parameters do not exhibit significant deviations over time, further confirming the robustness and reliability of the estimated relationships.

5. Conclusion and Recommendations

This research aimed to examine how resource allocation policies affect the overall performance of the banking system in Islamic banking. The banks in this system, guided by Sharia principles, primarily utilize two types of financial contracts: partnership contracts (based on profit and loss sharing) and exchange contracts (offering fixed returns). These two approaches are different in terms of risk, return, and monitoring requirements. While partnership contracts can yield higher returns aligned with economic conditions, they also involve greater risk and require more intensive oversight. In contrast, exchange contracts offer lower risk and more predictable returns, but may underperform in inflationary environments due to the fixed nature of their payouts. Using annual data from Iran's banking system (1986–2023) and using the ARDL method, this research assessed the long- and short-term effects of reallocating financial resources between these two contract types. The results show that a shift from partnership contracts to exchange contracts (which mean increasing in MTOM) is associated with an improvement in overall banking performance. These findings challenge the common assumption that increasing the share of exchange-based contracts weakens bank performance due to their fixed returns. In contrast, our results suggest that a higher allocation of resources to exchange contracts—relative to partnership contracts—positively contributes to banking system performance. This may be attributed to the lower risk profile and reduced monitoring costs associated with exchange contracts, which, despite offering fixed returns, provide greater stability and predictability for the banking system, particularly in uncertain or volatile economic environments.

Based on this insight, the study recommends that policymakers and banking institutions maintain or even strengthen the role of exchange contracts in their resource allocation strategies. Rather than prioritizing partnership-based instruments, which often involve higher risks, complex profit-sharing arrangements, and monitoring burdens, banks may benefit from emphasizing exchange contracts to enhance operational efficiency and financial stability.

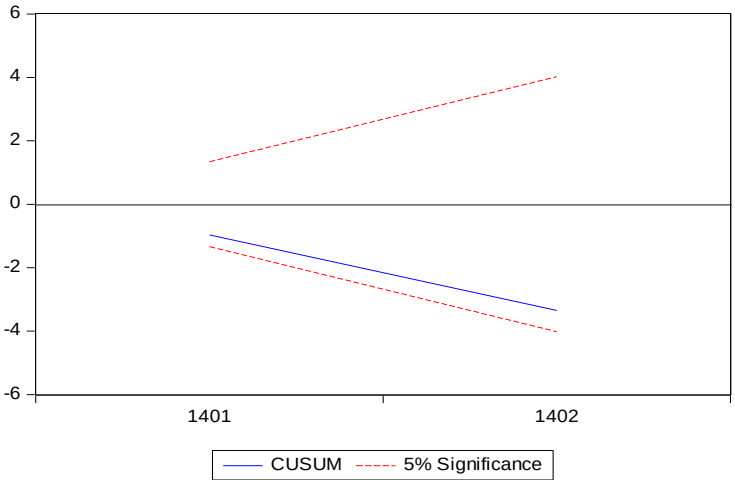

Figure2. The result cusum test
***Source**: Research Finding*

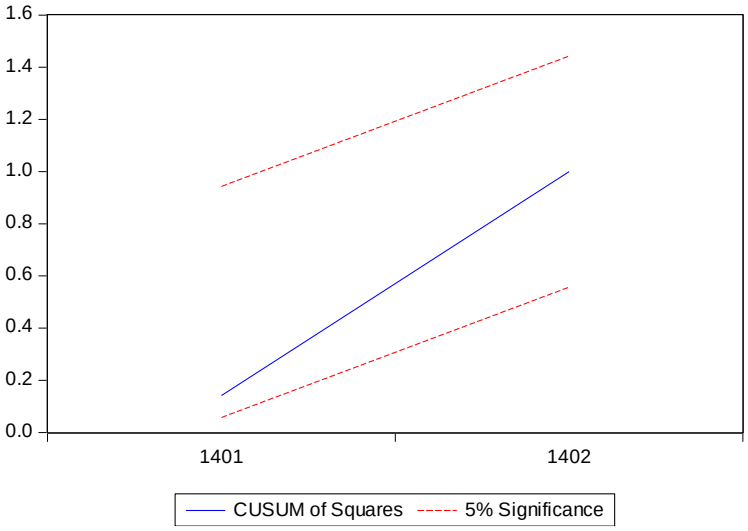

Figure 3. The result of cusum of squares test
***Source**: Research Finding*

Compared to previous literature, which often highlights the theoretical advantages of partnership contracts, this study offers an alternative empirical perspective. While some prior research has explored the effects of contract composition on macroeconomic inequality or banking stability, none has directly examined the impact of the ratio of exchange to partnership contracts on overall bank performance. By doing so, this study addresses a critical gap and contributes new evidence to the discourse on optimal contract structures in Islamic banking.

5.1. Recommendations based on these findings include

Resource Allocation: Banks are advised to prioritize exchange contracts in their resource allocation strategies, as these contracts have demonstrated a more stable and positive impact on banking performance. While partnership contracts may still have a role in specific contexts, emphasis should be placed on exchange-based instruments, especially under inflationary or uncertain economic conditions.

Risk Minimization: Given the lower risk profile of exchange contracts, banks can enhance system efficiency and profitability by reducing exposure to high-risk partnership contracts, unless adequate monitoring and profit-sharing mechanisms are in place.

Selective Use of Partnership Contracts: Where partnership contracts are deemed necessary, banks should apply them selectively in sectors with proven growth and stability, ensuring that the associated risks are justified by the potential returns.

In conclusion, the findings underscore the importance of a strategic emphasis on exchange contracts as a means to improve operational stability and overall performance. A cautious and well-managed approach to partnership contracts may complement this strategy when economic and sector-specific conditions are favorable.

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Conceptualization, methodology, validation, formal analysis, resources, writing—original draft preparation, writing—review and editing, and supervision were all performed solely by the author. The author has read and agreed to the published version of the manuscript.

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Conflicts of Interest

The authors declare no conflict of interest.

Data Availability Statement

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