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Competitive conditions in Islamic and conventional banking: A global perspective

Rima Turk Ariss *

Lebanese American University, Business School, P.O. Box: 13-5053, Beirut, Lebanon

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ABSTRACT

I analyze the competitive conditions prevailing in Islamic and conventional global banking markets, and investigate the possible differences in profitability between these markets, using a sample of banks across 13 countries during 2000–2006. The results suggest that Islamic banks allocate a greater share of their assets to financing activities compared to conventional banks, and they are also better capitalized. Different computed measures of competition indicate that Islamic banking is less competitive compared to conventional banking. A second-stage analysis shows that profitability significantly increases with market power, but this does not warrant higher profitability levels for Islamic banks.

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1. Introduction

Competition in banking has intensified over the past decades and is putting increasing pressure on bank returns. Major financial institutions are strategically entering new markets and/or offering a diverse spectrum of products and services to consolidate their presence and boost their profitability. Among such developments is the expansion of Islamic banking since 1975, and its growing recognition as a viable mode of financing.

Islamic banks have proliferated in the Far East and the Arabian Gulf and a large number of banking firms have diverted some of their operations away from conventional practices by setting up Islamic windows or establishing full-fledged Islamic banks. Countries like Malaysia and Bahrain are striving to be regional hubs for Islamic financial services. There are now about 270 Islamic financial institutions worldwide, including banks, mutual funds, mortgage companies, and *Takaful* or insurance firms. However, Islamic finance is not limited to stakeholders with common religious backgrounds. Britain has announced plans to turn London into the world centre of Islamic finance (Kerr, 2007); and international banks such as Citigroup, BNP Paribas, HSBC, and others are also expanding into this new segment of the industry.

In this study, I investigate competitive conditions in Islamic and conventional banking on a global level, and assess the implications of prevailing structures on bank profitability. Competitive conditions in banking are relevant for at least two reasons. First, the degree of market power may bear serious implications for financial stability. After the seminal article by Keeley (1990), many studies have shown that competition encourages moral hazard in banking (Hellmann, Murdock & Stiglitz, 2000; Jimenez, Lopez, & Saurina, 2007), although a counter trend provides theoretical predictions and empirical evidence that more market power might result in higher bank risk (Stiglitz & Weiss, 1981; Koskela & Stenbacka, 2000; Boyd & De Nicolo, 2005; Schaeck, Cihak, & Wolfe, 2009). Second, competitive conditions are likely to affect bank performance and efficiency (see Berger & Mester, 2003 for an updated review of the efficiency literature), in addition to equity capitalization levels (Schaeck & Cihak, 2007).

From a structural point of view, Islamic banks operate alongside of conventional banks in different countries and a parallel market for Islamic financial services has developed. Deficit and surplus units in the economy have the option to use the services provided by each mode of banking. If religious underpinnings for the provision of financial services do matter, then the bank clientele will choose to transact with full-fledged Islamic banks only. Even if one cannot rule out the possibility that customers might establish relationships with both types of financial institutions, Islamic banks' charter prohibits them from transacting with conventional banks unless no payment of a pre-determined rate of interest takes place in the process. In this light, it is reasonable to assume that the two segments of the banking market (Islamic and conventional) are separate and that inter-industry linkages are limited.

The segregation of these two markets is also valid from a regulatory perspective. Islamic banks operate under different principles compared to other financial institutions and they have unique risk profiles. Regulatory frameworks generally address their specificities in order to promote sound banking practices. In countries where both Islamic and conventional banks operate, central banks issue special circulars and promulgate new laws to cater for the regulation and supervision of Islamic banks. To illustrate, capital requirements to set up an Islamic

* Corresponding author. Tel.: +961 1 786456x1644.
E-mail address: rima.turk@lau.edu.lb.

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bank are much higher compared to those needed for establishing a conventional bank. Another example of industry-specific regulation tailored for Islamic banks relates to taxation. Under Islamic finance, when a customer needs to finance the purchase of a physical asset, the bank has to first own it before it can sell it to the customer for a premium (cost-plus sales). Thus, the Islamic bank has to pay registration fees, but the end customer will also incur similar fees with the conclusion of transfer of ownership. To increase the efficiency of the sale transaction and improve the competitiveness of Islamic banks, several Arab states as well as the UK exempt Islamic banks from double taxation.

This paper differs from previous work on various fronts. First, I assume that there is a global market for Islamic financial services that is distinct from conventional banking and that is not geographically limited to one country. Islamic (conventional) banks compete among each other on a global level, but not with other conventional (Islamic) banks, because the market segregates them to a certain extent. In countries where capital markets are relatively underdeveloped and where the banking sector serves as the main conduit to finance the economy, two parallel banking markets have developed. I select countries where both types of banks operate, and form two distinct samples of banks, one is conventional and the other is Islamic, to be later aggregated across all countries considered. No previous study has explored competitive conditions in both banking segments of the industry.

Second, I assess competitive conditions in Islamic and conventional global markets using a variety of key indicators, including traditional concentration measures, the PR *H*-statistic, and the Lerner index. Previous research on market structure in related countries uses traditional measures of concentration and the Panzar and Rosse (1987) *H*-statistic either in a single country framework for Islamic banking or in a cross-country context for conventional banking. Abdul Majid and Sufian (2007) report that market conditions are monopolistically competitive in the Islamic financial industry in Malaysia using traditional measures of concentration and the PR method. Al-Muharrami, Matthews, and Khabari (2006) also use traditional concentration ratios and the *H*-statistic and find that competitive conditions in banking vary across the Gulf Cooperation Council countries. Turk Ariss (2009) similarly uses the PR model to evaluate competitive conditions in Middle Eastern and North African conventional banking. No prior study to my knowledge has investigated competitive conditions across both Islamic and conventional global banking markets using a spectrum of proxies for competition.

Third, unlike previous literature, the analysis extends beyond assessing competitive conditions to explain differences in bank profitability across the two market segments, both in absolute terms and on a risk-adjusted basis, in a multivariate framework. Prior research reports that Islamic banks achieve higher records of profitability compared to conventional banks using comparative ratio analysis (Samad, 1999; Samad & Hassan, 1999; Iqbal, 2001; Hassoune, 2002). Haron (1996) examines the performance of Islamic banks after classifying them in monopolistic or competitive markets and controlling for bank market share. Bashir (2003) and Hassan and Bashir (2003) consider a set of internal and external banking characteristics as possible determinants of Islamic banking profitability in a cross-country context, and they control for macro-level indicators of competitiveness in the industry. I propose to directly investigate the importance of competitive conditions on bank profitability using both the PR *H*-statistic and the Lerner index, distinguishing among Islamic and conventional banks. Compared to conventional banking, Islamic banking is relatively young in terms of development and it is likely that a higher degree of market power prevails in the industry. If market players in the Islamic finance industry do command a higher degree of market power compared to their peers, are profitability conditions also significantly different? Is the embryonic Islamic banking industry a more lucrative business compared to the more mature conventional banking industry? What are the implications of the prevailing structures on risk-adjusted performance?

I find that Islamic banks have significantly different asset and portfolio compositions compared to conventional banks. Financing activities tie up a large fraction of their assets, and their capitalization is significantly better compared to conventional banks, notwithstanding non-significant differences in profitability. All proxies for market structure indicate that Islamic banks command a higher degree of market power compared to conventional banks. This, however, does not warrant higher profitability levels for the infant Islamic banking industry.

The rest of the paper is structured as follows. Section 2 provides a background overview on Islamic finance. Section 3 presents the evaluation methods used, and Sections 4 and 5 discuss the data and the empirical findings, respectively. Section 6 concludes.

2. Background on Islamic finance

A commerce law known as *fiqh al-mu'amalat* is the basis for the Islamic financial system. This law considers issues of social justice, equity, and fairness in all business transactions, and rests on the promotion of entrepreneurship, the protection of property rights, and the transparency and sanctity of contractual obligations. Under the precepts of the Islamic legal code known as *Shari'a*, a commercial transaction is permissible as long as it is free from *Riba* (interest), *gharar* (uncertainty), *maisir* (gambling), and *non-halal* (prohibited) activities.[1] Because of its socially responsible and ethical underpinnings, the new class of Islamic investments is appealing to both Muslims and non-Muslims who seek to invest in socially responsible products.[2]

The prohibition of interest is not exclusive to Islam, but common to all three Abrahamic faiths. Although the Koran does not explicitly justify the prohibition of dealings based on a pre-determined rate of interest, it is believed that the primary reason for doing so is to remove any form of injustice in business transactions. While, on the surface, this might conflict with the foundations of conventional finance with regards to basic concepts such as the time value of money, Islamic finance mandates a return on capital. However, this return on capital depends greatly on the performance of the activity being financed. Risk-taking, and not the passage of time, justifies the return on capital. It is noteworthy that lending and financing activities belong to entirely different spheres in Islamic finance. The first falls within the realm of charity to support the needy in the form of benevolent loans, while the second is most common in financing business activities where the reward is in relation to the investment rate of return.

Islamic financing services are developing phenomenally around the world, although most countries do not generally support *riba*-free environments. Recent figures indicate that global *Shari'a*-compliant assets under management stand at about $500 billion (Kerr, 2007). Although the size of the Islamic financial industry is still at very low levels compared to the $1.5 trillion of pre-2007-crisis assets for some of the largest commercial banks (including Barclays Bank Plc, UBS A.G, HSBS, Citigroup, BNP Paribas, and others), its rate of growth is impressive, averaging around 15% over the past three decades (Aggarwal & Yousef, 2000).

The development of the Islamic finance industry coincides with progress in the legal, accounting and auditing, regulatory, and governance fronts. An architecture of institutions has developed to fuel the growth and development of the industry. In 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) mandated the preparation of accounting, auditing, governance, ethics, and *Shari'a* standards. In 2002, the Islamic Development Bank based in Jeddah took the lead in establishing the International Islamic Financial Market (IIFM) in April, the Liquidity Management

[1] These include pork food, alcohol, and immoral activities such as prostitution and narcotics.

[2] London has become a major trading centre for Islamic funds and a quarter of all Islamic banking business in Malaysia is conducted by non-Muslims (Asokan, 2009).

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