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Dual market competition and deposit rate setting in Islamic and conventional banks

Céline Meslier[a], Tastaftiyan Risfandy[a,b,*], Amine Tarazi[a]

[a] Université de Limoges, LAPE, 5 rue Félix Eboué, 87031, Limoges Cedex, France

[b] Faculty of Economics and Business, Universitas Sebelas Maret, Jl. Ir. Sutami 36A, Surakarta 57126, Indonesia

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ABSTRACT

This paper addresses the issue of competition in dual banking markets by analyzing the determinants of deposit rates in Islamic and conventional banks. Using a sample of 20 countries with dual banking systems over the 2000–2014 period, our results show significant differences in the drivers of Islamic and conventional banks' pricing behavior. Conventional banks with stronger market power set lower deposit rates but market power is not significant for Islamic banks. In predominantly Muslim environments, conventional banks set higher deposit rates and further higher when their market power is lower. Whereas conventional banks are influenced by the competitiveness of Islamic banks, Islamic banks are only affected by their peers in predominantly Muslim countries. Our findings have important implications regarding competition and bank stability in dual banking markets.

1. Introduction

Islamic banking has substantially grown since the 2007–2008 global financial crisis. Islamic banking assets grew at an annual rate of 17.6% between 2009 and 2012 and are expected to grow at almost 20% per year until 2018 (The Economist, 2014). Islamic banks' total assets have reached US$ 1.9 trillion in 2014 (Hussain and Turk-Ariss, 2015) and are expected to rise to US$2.6 trillion by 2017 (The Economist, 2013). While Islamic finance accounts for a relatively small fraction of global banking assets (less than 2%), it has sharply increased its penetration in several countries and exceeds the threshold of 15%[1] of total banking system assets in at least 10 countries (Iran and Sudan with a full-fledged Islamic financial sector, Bangladesh, Brunei, Kuwait, Malaysia, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen) (Islamic Financial Service Board, 2015). Moreover, Islamic finance has expanded beyond Muslim countries, reaching Europe and Sub-Saharan regions. Islamic banks are present in Denmark, France, South Africa and the United Kingdom among others. How Islamic and conventional banks compete in such growing dual markets remains an insufficiently documented issue. In this work, we investigate how bank deposit rates are influenced by the concomitant presence of Islamic and conventional banks in an increasing number of countries.

The development of Islamic banking has led to an important literature investigating the potential differences between Islamic and conventional banks in terms of profitability, risk, business models, market structure and competition (see Abedifar et al. (2015) for a survey). Nevertheless, despite the growing presence of dual banking markets, where Islamic and conventional banks operate alongside, there is a scarce literature on the impact of dual banking market structure on Islamic and conventional banks' behavior. Moreover, the results of such studies are often mixed. While Turk-Ariss (2010b) finds that Islamic banks are less competitive than their conventional counterparts, Weill (2011) does not find significant market power differences between both types of banks, in contradiction with the view that Islamic banks may benefit from captive customers. Other papers look at the macroeconomic and social implications of further penetration of Islamic banks in the financial system as a whole. Gheeraert (2014) shows that the presence of Islamic banking in Muslim countries can boost banking sector development. Abedifar et al. (2016) highlight a positive impact of the market share of Islamic banks on financial

* Corresponding author at: Faculty of Economics and Business, Universitas Sebelas Maret, Jl. Ir. Sutami 36A, Surakarta 57126, Indonesia

E-mail addresses: celine.meslier@unilim.fr (C. Meslier), tastaftiyan.risfandy@staff.uns.ac.id (T. Risfandy), amine.tarazi@unilim.fr (A. Tarazi).

[1] The Islamic Financial Stability Board (IFSB) considers the Islamic financial sector as systemically important when the total Islamic banking assets account for more than 15% of the total domestic banking sector assets.

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deepening and economic welfare. They also find a positive relationship between the presence of large Islamic banks and the efficiency of conventional banks in predominantly Muslim countries. Cihak and Hesse (2010) further highlight that a higher market share of Islamic banks does not alter the soundness of the other banks in a given country, suggesting that both types of banks could compete on the same market without jeopardizing financial stability.

In this work, we question how bank competition in dual markets affects the deposit rate setting behavior of Islamic and conventional banks, an issue which is of great importance from both a market structure perspective and a financial stability perspective. Focusing on differences in deposit rate setting in dual markets is of particular interest due to the specific nature of Islamic banks' depositors. Islamic banks follow the Profit and Loss Sharing (PLS) principle. Transposed to banks this principle implies that profits and losses have to be shared between the borrowers and the bank and then between the bank and the depositors. Hence, the bank-depositor relationship in Islamic banking is not debt-based as in conventional banks. Islamic depositors are considered as "quasi-shareholder" and participate in bank funding through equity-based contracts, where Islamic depositors act as a source of funds and banks as a fund manager. Islamic depositors cannot claim a fixed rate of return on their deposits, a rate which will in fact depend on the bank's actual ex post profit. While Islamic banks and conventional banks are expected to set their deposit rates differently, empirical research does not report significant differences in their pricing behavior. Chong and Liu (2009) and Ito (2013) provide strong evidence that the deposit rates of Islamic and conventional banks in Malaysia are closely pegged. Investigating the deposit rates of conventional and Islamic banks in Malaysia and Turkey, Cevik and Charap (2011) show that conventional banks' deposit rates and PLS returns are cointegrated. Moreover, the authors find that conventional banks' deposit rates Granger cause returns on PLS accounts. Saraç and Zeren (2014) confirm such results and highlight a strong dependency between the deposit rates of Islamic and conventional banks in Turkey. Moreover, they also find evidence of bi-directional causality thereby highlighting more complex interactions between both types of banks than in earlier studies. While these papers provide statistical evidence of a co-evolution of deposit rates of Islamic and conventional banks, they do not investigate the determinants of deposit rates per se and to what extent they actually differ between both types of banks.

For the purpose of our study, we consider a sample of 98 Islamic and 386 conventional banks from 20 Muslim and non-Muslim countries where Islamic and conventional banks operate alongside. We first examine the determinants of deposit rates for each type of banks with a specific focus on the role played by market power. We analyze how both types of banks set deposit rates depending on the degree of their market power in possibly segmented markets (i.e. where Islamic and conventional banks compete for different depositors) or in integrated markets (i.e. where Islamic and conventional banks compete for the same depositors). On the one hand, one might argue that both types of banks do not compete with each other and that a depositor switching from a depository institution is more likely to go to a similar type of depository institution (Adams et al., 2007; Cohen and Mazzeo, 2007). In theory, the equity-based deposit accounts offered by Islamic banks should be very different from the debt-based deposit accounts of conventional banks. Moreover, Muslims are known to be reluctant to use conventional banks financial products which are not Sharia-compliant (Abedifar et al., 2016; Beck et al., 2013; Demirgüç-Kunt et al., 2013). In a segmented market, banks should be only influenced by the market conditions of their own segment. On the other hand, because some studies find that Islamic and conventional banks' deposit rates are closely pegged, one might consider that those banks compete in integrated markets with the same depositors. Nevertheless, it could also be argued that while religiosity might prevent depositors from Islamic banks to switch to conventional banks, Islamic banks could well attract depositors of conventional banks if they offer higher expected returns. We hence also examine the case of a one way/asymmetric competition where conventional banks are influenced by Islamic banks but not the other way round. In such a situation, conventional banks would be competing with both categories of banks, conventional and Islamic banks. We further investigate how Islamic and conventional banks react to stronger presence of Islamic banks and Muslim population. While these factors might not influence bank behavior in segmented markets, the behavior of both Islamic and conventional banks can be influenced by the importance of Muslim population and the presence of Islamic banks.

Our findings reveal notable differences in the drivers of deposit rates of Islamic banks and conventional banks. As expected, conventional banks with stronger market power set lower deposit rates but market power is not effective for Islamic banks. Moreover, conventional banks are influenced by the market conditions prevailing on the Islamic segment whereas Islamic banks are indifferent to the market structure of the conventional segment. We also find that stronger presence of Islamic banks and higher share of Islamic population are associated with higher deposit rates for conventional banks. Moreover, in countries with either a strong presence of Islamic banks or a high proportion of Muslim population, conventional banks set higher deposit rates which are even higher for the least competitive ones. Our results support previous findings (Abedifar et al., 2016; Baele et al., 2014; Farook et al., 2012) indicating that religious beliefs matter in dual markets and that they may well shape economic behavior (Bursztyn et al., 2015).

The contribution of this paper is twofold. First, our paper complements the existing literature on bank market structure. For instance, following the deregulation process which occurred during the 2000s in the U.S., numerous studies have investigated how U.S. banks of different type, size or scope compete together. Biehl (2002), Hannan and Prager (2004), Rosen (2007) highlight significant differences, in deposit price behavior, between multimarket and single market banks, with significantly lower deposit rates at multi-market banks. Moreover, these studies also highlight a strong influence of both local market concentration and presence of multimarket banks on the pricing behavior of single-market banks. However, Hannan and Prager (2004) highlight that single market banks' deposit price setting behavior is influenced by the market share of multimarket banks in local markets. Adams et al. (2007) findings' support the presence of market segmentation among different types of depository institutions (banks versus thrifts institutions). This limited competition both between single-market and multimarket banks and between thrifts and banks is confirmed by Cohen and Mazzeo (2007), indicating significant differences in consumer preferences for banking products. Among the different factors which might influence individual financial choices, many authors stress the importance of morality and religious belief (Bursztyn et al., 2015; Khan, 2010). Our paper brings a novel dimension to the existing literature on bank market structure by investigating the influence of religious belief in banking competition. Despite an abundant literature concluding that Islamic banks mimic conventional banks behaviors, these papers do not provide an analysis of the drivers of Islamic and conventional banks pricing behavior. To the best of our knowledge, our paper is the first to investigate if and how Islamic and conventional banks compete in dual markets and to what extent specific competition features might shape their behaviors. We show that even though prior literature has highlighted that Islamic banks mimic conventional banks when they set their interest rates (Cevik and Charap (2011); Chong and Liu, 2009; Ito, 2013; Saraç and Zeren, 2014), the determinants of such rates are very different.

Second, this paper also contributes to the debate on financial stability in dual markets. Increased competition can be detrimental for financial stability and among others, Hellman et al. (2000) theoretically show that deposit-rate ceilings can be necessary to prevent banks from competing through inefficiently high deposit rates possibly leading to destructive competition. We bring the issue of competition-