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AN ANALYSIS OF MARKET STRUCTURE AND COMPETITIVE DYNAMICS IN DUAL BANKING SYSTEMS

Islamic banks have proliferated and emerged as important players in the global banking industry especially in the Muslim-Majority countries. The recent increase in the number and market share of Islamic banks has intensified the competition in this new industry. Despite its importance, the increasing competition in Islamic banking market not only from its own Islamic peers, but also from commercial banks has not been adequately addressed nor its consequences have been investigated. This summary aims to shed the light the market structure and the evolution of the competition under dual banking system.

The total number of Islamic and conventional banks has increased over the last fifteen years in nine countries where Islamic banking is systemically important and/or growing rapidly as shown in figure 1. The increase from 159 banks in 2000 to 211 banks in 2014 represents a growth of 33%. Most of this increasing trend took place during 2000 to 2008. In the aftermath of the global financial crisis in 2008, the number of banks fell slightly until the end of 2010. Few banks entered the markets from 2011 to 2013, which slightly raised the total number of banks.

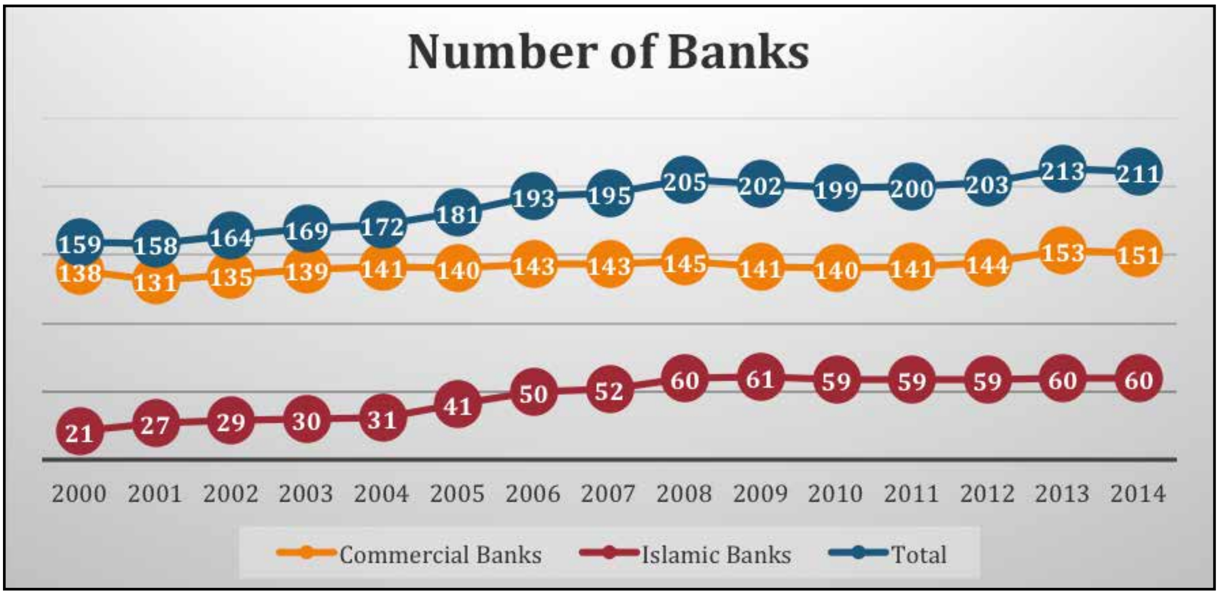


Figure 1: The Number of Banks, by Bank Type, 2000-2014
This graph shows the number of Islamic and conventional banks across 9 countries where Islamic banking is systemically important and/or growing rapidly. The countries are Saudi Arabia, Kuwait, Qatar, Bahrain, UAE, Malaysia, Turkey, Pakistan and Bangladesh. The data are from Bankscope.

Analysing the breakdown over bank type shows that the increase in the number of banks was most pronounced for Islamic banks. The number of Islamic banks has sharply increased from 21 in 2000 to 60 in 2008 representing a growth of 186%. Surprisingly, the number of Islamic banks does not show any improvement since 2008. Detailed information about the number of Islamic banks in each country are shown in figure 2. Malaysia showed an abrupt jump from 2 Islamic banks in 2004 to 17 Islamic banks in 2008. This remarkable growth in Malaysia has been driven by two factors. First, the transformation of Islamic windows of conventional banks to Islamic subsidiaries. Second, the opening of the Malaysian market to foreign Islamic banks.

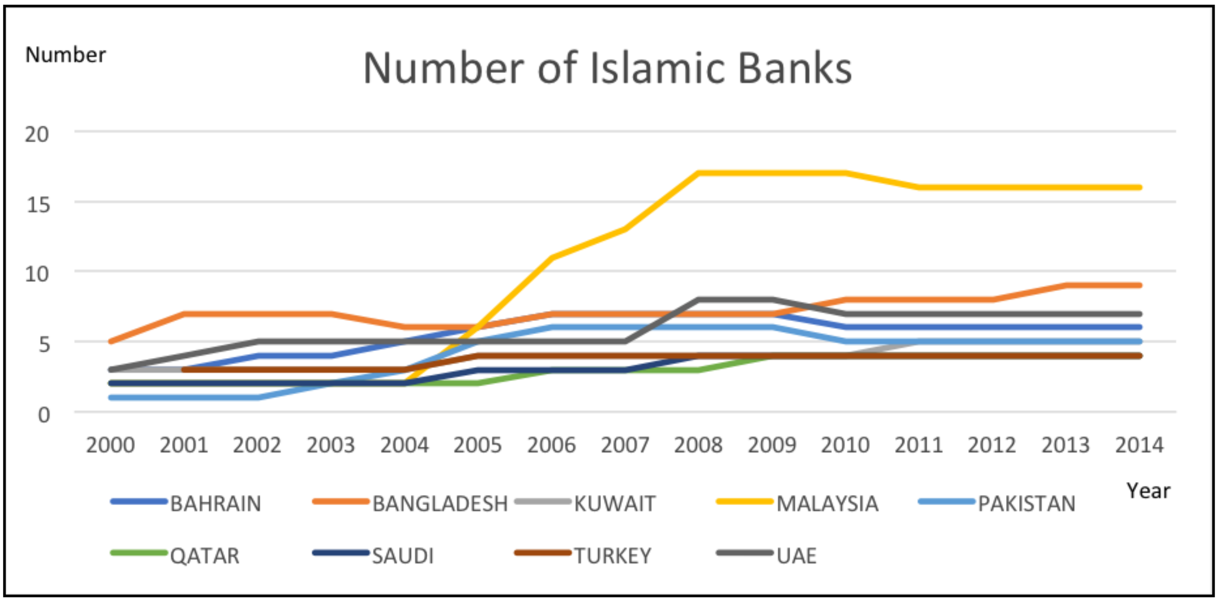
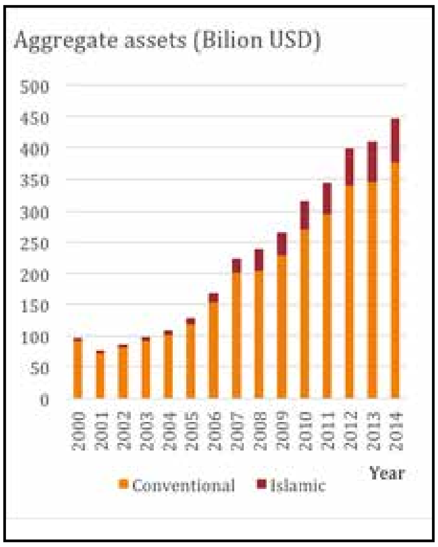


Figure 2: Number of Islamic banks by country, 2000-2014
This graph displays the increasing number of Islamic banks across the 9 countries, it can be seen that by far the largest number of Islamic banks are working in the Malaysian market. The data are from Bankscope.

In contrast, the number of conventional banks showed only a slight increase of 9% from 2000 to 2008. With a slight decrease after the global financial crisis, the market witnessed a slight growth after 2011, mainly in Turkey and Bangladesh. Indeed, the number of conventional banks did not increase that much in most countries under the study while it did not change at all in the whole period in the Saudi and Kuwaiti Markets.

However, aggregate assets of banks have grown continuously over the last 14 years as shown in figure 3-1. Comparing the growth of aggregate assets for conventional and Islamic banks, figure 3-2 shows that the growth of Islamic banks assets is considerably higher than their conventional peers from 2005 to 2008. This difference is explained by the increase in the number of Islamic banks, which doubled from 31 in early 2005 to 60 at the end of 2008. Although the growth rate of aggregated assets dropped drastically after the global financial crisis, the assets of both Islamic and conventional banks continued growing in the post crisis period. However, the growth rate of assets for Islamic banks again remained slightly higher compared to the conventional banks.

The higher growth rate of Islamic banks assets has resulted in increasing market share of Islamic



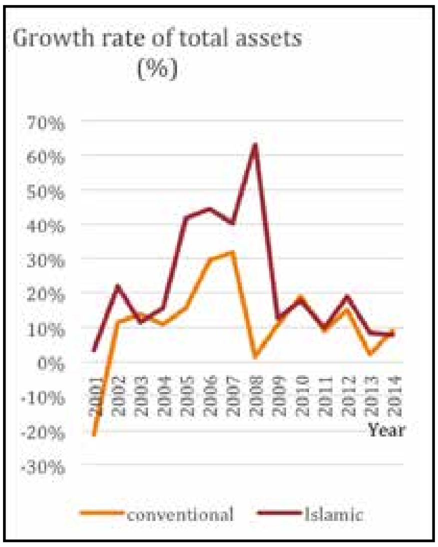


Figure 3-1: (Left) Aggregate Assets of Banks by Bank Type, 2000-2014
This figure shows that the assets of both Islamic and conventional banks for the 10 countries grew over the period of 2000-2014.

Figure 3-2: (Right) Growth Rate of Total Assets by Bank Type, 2001-2014
The growth of Islamic banks is higher than in the conventional banks over the period of 2001-2014.

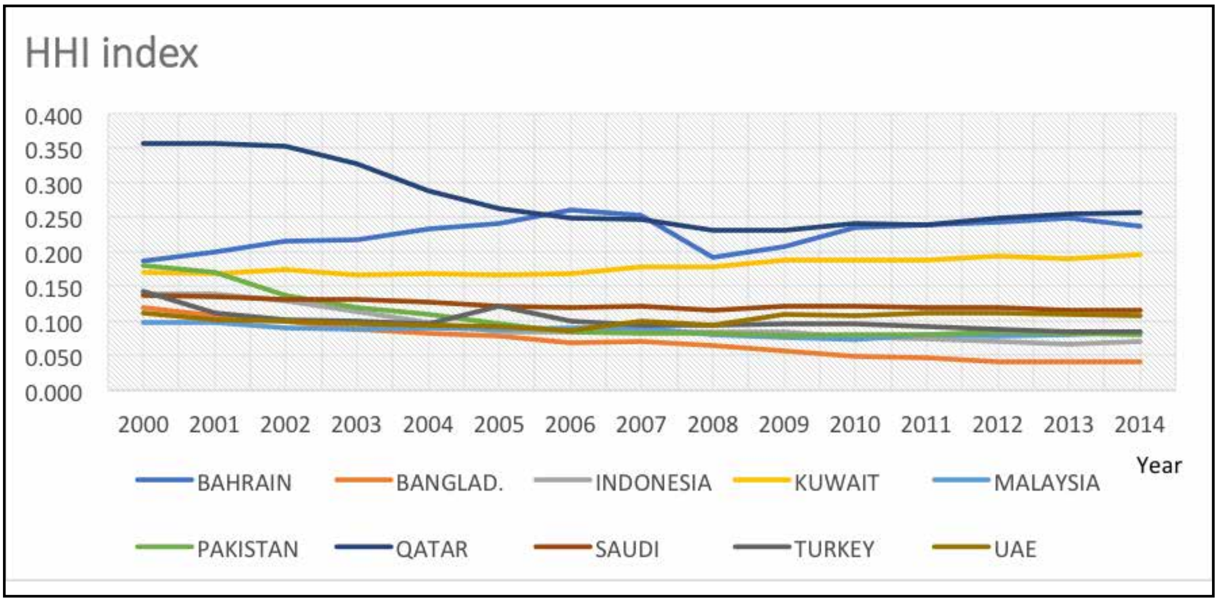


Figure 4: HHI measure of market concentration by country

This figure compares HHI index of market concentration across the countries of dual banking systems over the period 2000-2014. The data are from Bankscope.

banks. Even though the number of Islamic banks did not grow after 2008, their total market share (Islamic banking penetration) has grown continuously.

The increasing number and market share of Islamic banks changed the market concentration in countries with dual banking system. Concentration ratio C3 is the ratio of sum of the total assets of the three largest banks to the sum of total assets of all the banks in the country. Analysing C3 shows a decreasing trend in the concentration in most of the markets in the sample. Much of this decline in concentration can be attributed to two factors. The first reason may be the emergence of new Islamic banks with increasing market shares. For example, Masraf Al Rayan in Qatar, which started operations in 2006. It had 8% of Qatari banking market by 2014. Second, the establishment of Islamic subsidiaries of conventional banks reduced the market share of its parent conventional banks to the benefit of its Islamic subsidiaries. For instance, the market share of Maybank, the largest conventional bank in Malaysia, dropped from 19.5% to 17.8% in 2008 when it established its Islamic subsidiary: Maybank Islamic with 2.2% market share. It is also noteworthy that the three largest banks in each country in the study are conventional banks, with the exception of Saudi Arabia, Qatar, Kuwait, Bahrain and Bangladesh where one of the top three largest banks was an Islamic bank. Indeed, despite the remarkable growth of Islamic banks, conventional banks are still the largest banks in dual banking systems.

Further, we use another measure of market concentration, namely, Herfindahl-Hirschman Index (HHI), which considers the assets of all banks in the market. Analysing HHI index shows a declining trend in market concentration in most of the countries except Bahrain and Kuwait. Figure 4 represents HHI for all countries in one graph. Two countries show high market concentration1 over the whole period, namely, Qatar and Bahrain. While the Kuwaiti market turned from moderately concentrated to highly concentrated, the Saudi and UAE markets are considered as moderately concentrated markets. Notably, none of these GCC countries is considered as low concentrated market. In contrast, most of the non GCC markets in the sample turned from moderately concentrated to low concentrated. The exception is the Malaysian market, which remains low concentrated over the entire period.

Overall, analysing market structure and dynamics in dual banking systems shows an increasing in the number and market share of Islamic banks, which has improved the competition in these markets. This motivates further researches in this area to assess the impact of increasing competition on banks' performance, financial stability and social welfare in dual banking systems.

1 As a general rule, an HHI below 0.10 (1,000 points) signals low concentration, while an index above 0.18 (1,800 points) signals high concentration. For values between 0.10 and 0.18 (1,000 points and 1,800 points), an industry is considered to be moderately concentrated (European Central Bank (ECB), 2014).