STRUCTURAL CHANGES, COMPETITION AND BANK STABILITY IN MALAYSIA'S DUAL BANKING SYSTEM

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Malaysia is well acknowledged to be a frontrunner in the dual-banking system, referring to the co-existence of the Islamic banking system and conventional banking system. Propelled by the aim to establish Malaysia as an international hub of Islamic finance and the need to have a stronger and more resilient banking sector in the aftermath of the 1997/1998 Asian financial

crisis, policy initiatives have been put in place to increase the number of Islamic banking service providers and to consolidate the banking sector, particularly the conventional banking sector. As a result of the former, the Islamic banking sector now comprises 16 Islamic banks – 2 full-fledged domestic Islamic banks, 3 full-fledged foreign Islamic banks and 11 Islamic bank subsidiaries of conventional banks, the development that makes Islamic banking to have significant presence in the Malaysia's banking scene. Meanwhile, the banking sector consolidation initiative witnessed mergers and acquisitions of the then existing banks resulting in substantial reduction in the number of conventional commercial banks in the market. The number of conventional commercial banks declined from 35 in 1998 to 22 in 2009 and then, with new additions of foreign banks, increased to 27 at the end of 2016.

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Against the backdrop of these developments, the following questions seem inevitable: what has been the competitive environment shaping the banking industry in Malaysia since the Asian crisis? Are Islamic banks losing market power in the presence of more Islamic banking service providers and consolidated conventional banking sector? Have conventional banks gained more market power? How do changes in bank competition and banking market concentration affect the stability of Islamic and conventional banks? Are these two types of banks affected differently? The answers to these questions are not at all obvious in lights of contradicting competition-stability and competition-fragility views and empirical evidence available for both.

Empirical Approach

Our objectives are to assess the competitive conditions of the Malaysian banking industry against the backdrop of structural changes and consolidation initiatives and analyse the competition - stability relations for conventional and Islamic banking sectors. Following Schaeck et al. (2009), Fu et al. (2014) and Lapteacru (2017), we employ concurrently the bank-level competition and market-level concentration represented respectively by the Lerner index and the 3-bank concentration ratio. In addition, we consider the sector-level concentration measures, i.e. 3-bank concentration ratios of the conventional banking sector and Islamic banking sector, to gauge the risk implications of the market structures at the sector level. We

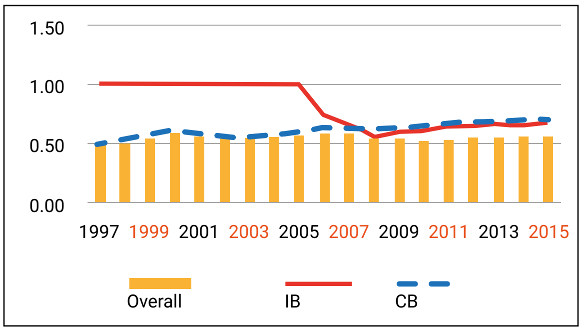

Figure 1: 5-Bank Concentration Ratio

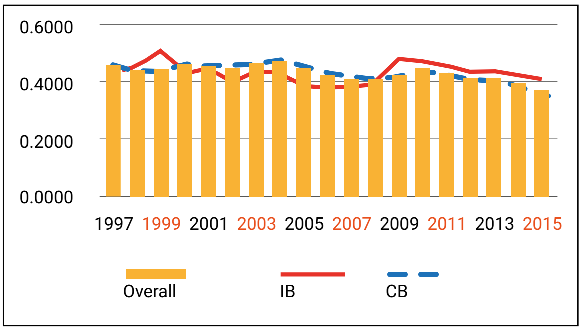

Figure 2: Weighted-average Learner index

use an unbalanced panel dataset of Malaysian commercial banks that includes 21 conventional banks and 16 Islamic banks and covers the period 1997 – 2015. In the analysis, we employ a panel modelling approach to address the competition – stability relations. We estimate the model using the Least Squares Dummy Variables (LSDV) and bias-corrected LSDV estimators as well as GMM.

Malaysia's Competition Landscape

As the figure 1 above shows, the changes in the overall banking market concentration over the sample period is marginal. The concentration at the sector level (i.e. for each type of banks), however, demonstrates noticeable changes. Its evolution aptly reflects the outcome of the conventional banking consolidation exercise and the increasing number of Islamic banking service providers. While these changes are notable, we may characterize the structure of the Malaysian banking industry as highly concentrated.[1] Nonetheless, noting that the weighted-average Learner index in figure 2 is an inverse measure of competition, it is observed that the increasing concentration of the banking industry in Malaysia has not been translated into a less competitive market. Overall, there is no significant mean difference between conventional banks' Lerner index and Islamic banks' Lerner index. Intertemporally, however, they tend to behave differently. The market power/competition of the conventional banking sector mirrors well the overall market power of the banking industry. This is not surprising since the conventional banking sector remains dominant despite the increasing penetration of the Islamic banking.

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Competition, Concentration And Stability Relations

Assessing the risk implications of market power and market concentration on bank risk, our various estimations indicates the following conclusions. First, supporting the competition – stability view, we find market power to be detrimental to conventional bank risk. The market power, however, has no significant effect on Islamic bank risk. Second, we find limited evidence that the overall market concentration increases bank risk. And finally, we observe potential two-way effects between the conventional and Islamic banking sectors. Islamic banking market concentration tends to increase conventional bank risk. By contrast, conventional banking concentration appears to exert risk-mitigating effect on Islamic banks. While these findings vindicate the bank consolidation and restructuring initiatives in the aftermath of the Asian crisis, policy makers should monitor bank market power as well as be cautious of the risk implications of further market consolidation.

1 The five largest banks have more than 50% of the asset share. Likewise, the five largest conventional banks and five largest Islamic banks hold more than 50% of the bank assets in their respective market segments.

***Notes:**
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