CONCENTRATION, COMPETITION, AND EFFICIENCY OF MALAYSIAN BANKS: ISLAMIC VS CONVENTIONAL BANKS

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ABSTRACT

The presence study aims to examine the market concentration, competition and the efficiency performance of conventional and Islamic banks in Malaysian banking industry over the period of 2008 to 2014. This study employs concentration ratio and Herfindahl-Hirschman Index to measure the market concentration while H-statistics value computed by Panzar-Rosse method serves as the indicator of the market competition. Last but not least, the Data Envelopment Analysis is used to assess the efficiency performance of Malaysian banks. The results of market concentration show conventional banks are more concentrated and the H-statistics results suggest Malaysian banks are operating under monopolistic competition. Interestingly, the efficiency results indicate the foreign banks are more efficient than its counterpart under conventional banking; vice versa, the domestic banks are more efficient in the Islamic banking system.

Keywords: *Efficiency, Concentration, Competition, Banking, Malaysia*

1. INTRODUCTION

Competitiveness conditions in banking sector require banks to take initiatives to analyse the structure of the market; once the banks recognize the market structure, banks can set high prices and this creates the market power (Hamza & Kachtouli, 2014). Iveta (2012) states market power occurs due to the collision in conduct and the large firm dominates the market. Competitiveness in the banking sector is important to the economy because it indicates the development of the sector and economic growth (Iakova et al., 2013). Fries and Taci (2002) claim outputs increase with the banks activities, which trigger the competitive condition of the banking sector. On this note, banking competition causes banks to monitor their performance as well as encourage banks to develop new products and services to be competitive (Aloshyna, 2013). Since the number of banks keeps increasing, competitiveness in the banking sector has become an interesting topic for the management of the banks and academics (Weill, 2011).

There are two contradict views with regard to competition; whether competitive conditions promote financial stability or whether competition triggers risks, known as competition-fragility. In competition-fragility link, the hypothesis postulates that in the competitive environment, small banks are competing with other banks and they are willing to take the risks (Labidi & Mensi, 2015); hence, this has made that competitive environment become more fragile (Yaldiz, 2010). Hong and Wilson (2011) add when competitive conditions increase, some banks tend to avoid the fragile conditions by not taking more risks. On the contrary, the competition-stability posits competitive environment encourage banks to perform better involving the high-interest rates besides taking the risks; the competitiveness of banking system increases as well as yields a better profit (Coccorese & Pelecchia, 2012).

With respect to the developments in banking, the increased competitive forces due to structural reform in banking environment would stimulate the incumbents which operating inside the production frontier. Theoretically, structural reforms in banking generate a more concentrated market that results in a reduction of bank competition; thus, the increased concentration may intensify market power and hinder the realization of competition. In other words, the higher the concentration, the lower the competition and the higher market power as enlightening by structure-conduct-performance hypothesis (Mason, 1939; Bain, 1951). On contrary, the efficient-structure hypothesis infer that the superior performance of the efficient