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FEATURES OF ISLAMIC AND TRADITIONAL BANKING IN
DUAL BANKING SYSTEMS

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Abstract

Banking development implies many changes and transformations, which concern not only the activities of financial institutions, but also creating new models of financial transactions. One such model is the Islamic Financial Management System. For the last 30 years, it has been actively developed. Current trends in the development of financial markets and the banking system involve many factors that contribute to the volatility of the economic system both at the level of the global economy and within the national borders. The Islamic financial services industry has repeatedly reflected the more stable dynamics of its development and the presence of a more sustained response to negative and crisis effects of external factors of the global economic turbulence. Accordingly, the relevance of the study on the development and efficiency of the Islamic finance industry is increasing. This purpose of this study is to identify and systematize the main approaches to compare the performance of the two financial models. The study revealed that the Islamic bank differs from traditional banking institutions in both the specifics of individual states and the architecture of national banking systems, and similar identical characteristics that indicate an insignificant difference in the effectiveness and sustainability of the two models.

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Keywords: Islamic banks, Islamic finance, traditional banks, banking system, bank efficiency



1. Introduction

The Russian economy has long needed a radical reform of the banking sector in terms of attracting additional financial capital from the external models of banking business. One of the most promising directions for the development of the banking system and the construction of a new stage of banking regulation is a dual banking system, which could include the activities of traditional credit organizations and Islamic financial institutions concerning mechanisms taking into account foreign experience. In this case, it is important to consider how effective and competitive Islamic banks may be compared to traditional banks in individual countries.

One of the issues worth paying attention to in the banking literature is the contrast between the risky behavior of different banks and the factors that force banks to adopt different risk structures. “Excessive competition between banks may jeopardize the solvency of individual institutions and, at the aggregate level, undermine the stability of the entire banking system”, which means that bankrupts are always accompanied by increased competition in the banking market. Consequently, the impact of competition in the banking sector is one of the key factors influencing risk acceptance by banks.

The emergence of the Islamic banking system as an alternative banking system added another dimension to the theory of competition in a dual banking system. The nature and scale of Islamic banks are different from the traditional banking system, as Islamic banks seek a reasonable distribution of wealth and income, which may serve the basis for additional risks. In the dual banking system, Islamic banks face competition not only from their peers, but also from their traditional colleagues. It is clear that Islamic banks differ from their traditional counterparts in terms of sources and the use of funds that will influence their risky behavior. Islamic banks are also small in size and have fewer opportunities for diversification (due to the religious nature of operations), which increases the pressure on the riskiness of the system. Despite the fact that some Islamic banking products are complex in nature, some business mechanisms and management structures allow Islamic banks conducting high-risk transactions, achieving better results and maintaining higher capitalization than traditional banks (Mollah et al., 2016).

The study on the impact of competition on bank risk behavior has always focused on traditional banks and lacks data on Islamic banks (Berger et al., 2009). There is sufficient evidence in the traditional banking system that shows that a systematic crisis is more evident in countries where banks are concentrated and have less competition (Schaeck et al., 2009). On the other hand, studies also showed a compromise between competition and stability (Leroy, 2017).

2. Problem Statement

Although there are some empirical studies comparing the market power between Islamic banks and their traditional competitors, these studies did not pay much attention to how competition may influence the risk-taking by Islamic banks. Despite the fact that Islamic banks are rapidly developing in the modern economy, there is little systematic and regular analysis and study on the impact of competition on the adoption of bank risks by Islamic banks. Most previous studies were only focused on comparing banking performance, such as profitability and financial stability in dual banking systems. Although the study conducted by Sahut et al. (2011) focused on comparing the market power of Islamic

and traditional banks; these studies did not cover any connection between competition and the risky behavior of Islamic banks. Besides, Dimov and Smirnov (2019) considered the functioning of double banking systems through the prism of risk management, where they came to the conclusion that there are no fundamental differences in approaches to managing the main types of banking risks. Both Islamic and traditional banks are characterized by market, operational and liquidity risk, which are subject to regulation within the framework of Basel II and III standards. The interest in this topic has increased only in the last couple of years, especially in the context of a dual banking system.

3. Research Questions

The present study addresses the following issues:

- To assess the current trends in Islamic finance taking into account historical retrospectives.
- To compare the development dynamics of Islamic finance industry and the total banking assets of traditional banking in countries with a dual banking system.
- To consider approaches to compare the two models of banking in terms of risk acceptance: Islamic and traditional.
- To identify distinctive and similar features of Islamic and traditional banking models.

4. Purpose of the Study

Taking into account the objectives and subject of this study, the main purpose is to determine the role of risks in the banking activities of Islamic and traditional models, as well as the influence of this indicator on the market position of two sectors of banking business in the countries with a dual banking system.

5. Research Methods

In order to achieve this purpose and solve a number of established tasks, a logical synthesis of approaches to the comparative assessment of the two types of banking business in the countries with the dual banking system was carried out. The study is based on the assessment of two banking models for 10 countries (Bahrain, Bangladesh, Indonesia, Kingdom of Saudi Arabia, Kuwait, Malaysia, Pakistan, Qatar, Turkey, and the UAE), in which Islamic finance is actively developing, but the banking assets of the traditional model are present. The dynamic analysis of data series for the period of 2007–2019 is also used, characterizing trends in the development of the global industry of Islamic finance and traditional banking assets. The comparative analysis was used to identify distinctive and similar features in approaches to risk acceptance in two banking models.

6. Findings

In 2019, the total assets of Islamic banks accounted for about \$2.9 trillion.

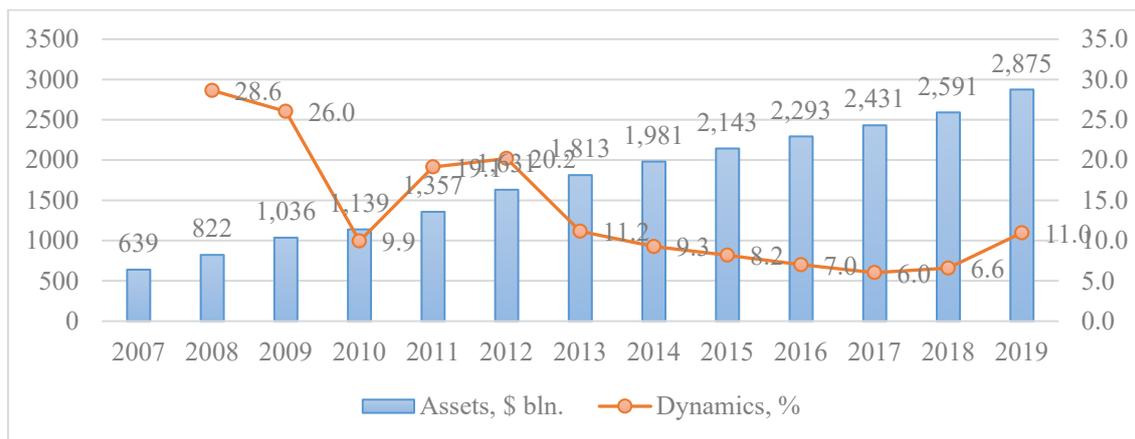


Figure 1. Dynamics of the global Islamic finance industry assets over 2007-2019

In the global aspect, the popularity of Islamic banking and finance continues to grow. After four years of declining development rates, this industry once again rose by 6.58 % to the level of annual asset growth during 2018 – from 2.431 trillion US dollars by the end of 2017 to 2.591 trillion US dollars by the end of 2018 (Fig. 01).

In dollar terms, the total volume of Islamic financial assets increased by \$285 billion in 2019. Banks continue to dominate the global Islamic economy with 79 % of the world’s Islamic financial assets owned by Islamic banks and Islamic windows, as well as subsidiaries of traditional banks. About 60 % of all Islamic financial assets belong to full-fledged Islamic banks (\$1.56 trillion). There is a natural and temporary slowdown of these processes caused by macroeconomic conditions in countries where Islamic finance is significant. On the other hand, there are some fundamental problems that began to reduce the industry in the period of 2012–2017. Besides, it seems that the studied industry has once again begun to gain momentum, as evidenced by a slight increase in the growth rates in 2019.

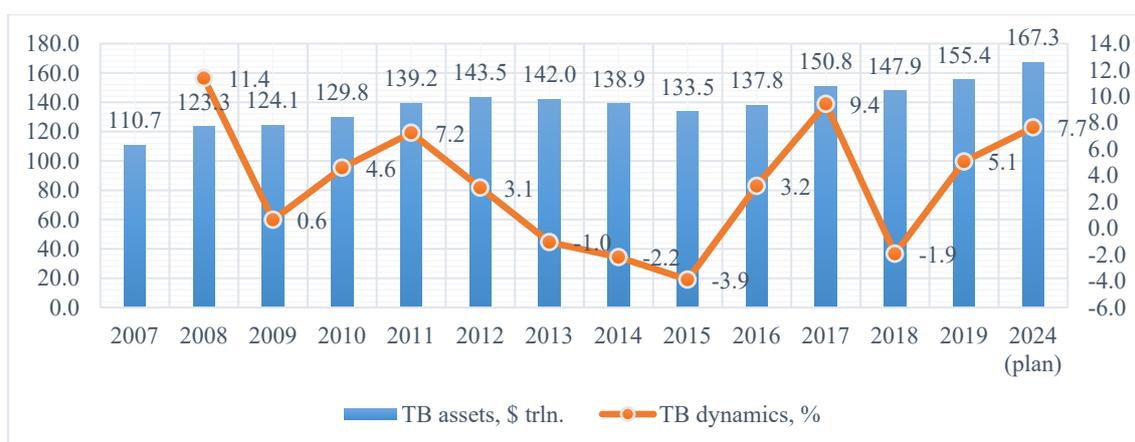


Figure 2. Dynamics of global banking assets over 2007–2019

Figure 02 shows a great gap in the banking market between Islamic and traditional models. Considering the trends of Islamic and traditional banking development in the world economy, let us

assess the state of the dual banking system in Islamic countries. Table 1 shows a comparison of the total number of Islamic and traditional banks, which demonstrates that Islamic banks dominate the banking systems of such countries as Bahrain and Malaysia. However, the banking systems of other countries may be seen as developing.

Table 1. Distribution of Islamic and traditional banks by country

Country	All banks	Traditional banks	Islamic banks
Bahrain	19	8	11
Bangladesh	28	25	3
Indonesia	37	34	3
Kingdom of Saudi Arabia	12	9	3
Kuwait	9	6	3
Malaysia	28	13	15
Pakistan	2021	16	5
Qatar	9	6	3
Turkey	24	20	4
UAE	2021	12	9
Total	208	149	59

The importance of Islamic banking in the banking sector can be shown in Table 2, which represents the distribution of the total assets of both banking concepts.

Table 2. Distribution of total assets between traditional and Islamic banks

	2008		2011		2013		2015		2018	
	Mln (US\$)	%								
Traditional banks	1,197,910	90.21	1,855,779	86.25	2 356 262	85.90	2 784 361	85.04	3 245 259	84.48
Islamic banks	130 061	9.79	295 866	13.75	386 738	14.10	489 765	14.96	578 676	15.52
Total	1,327,972	100	2 151 646	100	2 742 999	100	3 274 126	100	3 823 935	100

The table shows that between 2008 and 2018 there was a significant increase in the size of Islamic banking industry. However, the size of traditional banking industry during this period decreased from 90.21 % in 2008 to 84.48 % in 2018. The total assets of Islamic banking increased significantly from 9.79 % in 2008 to 15.52 % in 2018.

Taking into consideration the observed differences between Islamic and traditional banking business models, it is likely to expect changes in efficiency dynamics. However, the underlying dynamics of this effectiveness has hardly been studied.

Among the many common characteristics that studies are designed to show, we may note that Islamic banks are more profitable and have excellent asset quality and capitalization. They also have a similar risk profile comparing with their traditional counterparts and demonstrate higher technical efficiency.

It is argued that a distinct Islamic profile expands diversification opportunities for investors (Alexakis et al., 2017). Conversely, some Islamic actions may be adversely affected by religious restrictions on stock trading (Alhomaiddi & Kabir Hassan, 2017). Moreover, Islamic banks are particularly interested in development and economic well-being in low-income countries. Part of this may be attributed to their relatively higher liquidity levels.

Financially harmonized banking systems have various sources of income and higher liquidity; they are more profitable and financially stable (Izzeldin et al., 2020). The development of Islamic finance system has positive correlation with the economic growth. However, if the institutional structure is underdeveloped, this reduces this positive impact. Thus, to accelerate the economic growth through the development of Islamic banking, a country also has to develop appropriate legislation and supporting infrastructure. Numerous attempts were made to attract Islamic financial assets to the Russian economy (Archakova-Uzhakhova, 2019), but they were not successful because of this.

7. Conclusion

Islamic banks have less market power than traditional banks (Tashtamirov et al., 2020). It is also clear that both larger Islamic and traditional banks tend to take on more risks, since common assets have a significant positive relationship between loan-loss reserves for both types of banks. Islamic banking, however, with its religious system makes it possible for them to have more capital and be more profitable than traditional banks.

The future of Islamic banking seems brighter than that of traditional banking, since Islamic banking does not suffer from global financial crises and economic shocks as much as traditional banking.

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