



COMMERCIAL BANK NON-INTEREST FEE CHARGES: ARE FEE CHARGES DIFFERENT BETWEEN ISLAMIC BANKS AND CONVENTIONAL BANKS? EVIDENCE FROM BANGLADESH

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ABSTRACT

In the Western world, consumers complain about the soaring of non-interest bank fees during the recent years, the post global financial crisis in particular. Commercial banks charge a variety of non-interest fees for their transactions. This paper empirically tests whether the free charges are significantly different between conventional commercial banks and interest free Islamic banks. The average noninterest expenses to assets are 0.017 and 0.011 for conventional banks and Islamic banks respectively. The paper finds, using parametric test and nonparametric tests, no significant differences in noninterest expenses between conventional banks and Islamic banks. The competitive banking market of Bangladesh, suggested by low Herfindahl-Hirschman Index, is an important factor for the equality of mean fee charges between the conventional banks and the Islamic banks.

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JEL Classification: G21, G15, L11.

Contribution/Originality

This paper contributes to the existing banking literature by investigating whether there are differences in noninterest expenses between conventional banks and Islamic banks. This study applies parametric and non-parametric statistical tools. The paper's primary contribution is the finding that there is no difference in noninterest expenses between the conventional banks and the Islamic banks.

1. INTRODUCTION

In Bangladesh there are at present forty-one banks operating. Of them seven banks are Islamic banks. They operate on 'Shariah' (Quran and Sunnah) based principles. The rest of the banks operate on conventional based i.e. interest based principles. However, the basic objective of the two

types of banks, although they operate on diametrically different principles and modes, is the same i.e. minimizing costs and maximization profits.

Commercial banks are intermediaries. They channel funds from savers to lenders. In channeling funds banks charge not only interest but also fees (non-interest) for transactions. For every transaction banks incur two types of expenses (i) interest expenses and (ii) non-interest expenses. Interest expenses are spent in mobilizing deposits. Interests are provided to lenders/lavers to compensate for their postponement of current consumption. The higher the interest rate on deposits the higher the saving and deposits (ii) Non-interest expenses are bank's operating expenditure. Noninterest expenses include fees charged for stopping payment on a check, fees charged for writing a check that is returned for insufficient funds, overdraft fees, fees charged for withdrawing cash at an ATM not owned by the account holder's bank, fees charged for use of an institution's ATM, and credit card annual fees. The major non-interest expense is the employees' compensations.

All commercial banks—conventional banks and Islamic banks—charge fees. However, Islamic banks are a different breed of bank. The major differences in the mode of operations are: (i) Islamic banks do not operate on interest as interest (riba) is prohibited in Islam. (ii) The avoidance of interest leads Islamic Banks to the development of Mushraka and Muderaba contracts where there is no predetermined fixed interest.

Since Islamic banks are a different breed of banks and their modes of operation are different than that of conventional banks, it is a natural question: are fee charges i.e. noninterest expenses of Islamic banks different than that of conventional banks? This paper empirically examines this issue in the context of the Bangladesh banking industry.

The study is important for bankers and depositors-lenders. Once the comparative fee charges between the conventional banks and Islamic banks are known, bank managements (i) can reallocate and redirect their fee incomes in the best possible way for maximizing profits. (ii) Bank management can reassess their fee charges for becoming more competitive in the fee markets.

The study benefits the depositors-borrowers. The depositors-borrowers can minimize their fee costs. They can choose which banks (Islamic banks or conventional banks) to approach for deposits and borrowing for minimizing fee expenses. They can avoid banks that charge high fees for similar transactions.

Most importantly, the survey of literature shows that there are no studies on this issue. As such, this study will contribute to the banking literature by providing a good insight of fee costs of the conventional vis-à-vis Islamic banks of Bangladesh.

The paper is organized as: The mode of the operation of Islamic banks and the conventional banks are discussed in Section 2. Section 3 provides a brief survey of literature. Section 4 discusses data source and empirical methodology. Results and conclusions are provided in Section 5.

2. MODE OF OPERATION OF ISLAMIC BANKS AND CONVENTIONAL BANKS

2.1. Islamic Banks

Although both conventional and Islamic banks operate side by side and compete in the markets, there are differences in the mode of operations and productions. Islamic banks' modes of operation are quite different from conventional banks. The most important features that distinguish Islamic banks from conventional bank and provide the theoretical foundation of Islamic banks are the following:

First, Islamic Banks do not charge interest for all transactions. As interest¹ is prohibited in the Divine book of Islam, interest free transaction is the foundation of Islamic banks. By fixing a predetermined rate of return (interest), lenders (conventional banks) do not share the risk of losses in business. Interest provides assured income to lenders and it is the life and blood of conventional banks. Islamic banks do not lend rather they participate in the investment process and, therefore, do not earn fixed interest income.

Second, the avoidance of interest leads to the Profits and loss sharing (PLS) mode of operation. The PLS is the cornerstone and the most distinguishing feature of Islamic bank. Based on the nature of contracts, PLS contracts may be classified into two broad categories: 'Musharakah' (partnership) and 'Mudaraba'(trust financing). These two types of contracts are the only two products that fall into equity type contracts (Hamwi and Aylward, 1999). They are based on the profit and loss sharing (PLS) principle. These two products are very special to Islamic banking² and provide the most distinguished characteristics of Islamic banks.

'Musharakah' (partnership):

Under this equity type contract, 'Musharakah' (partnership), both parties provide capital. Profits and losses are shared (PLS) by contracting parties. Risk and rewards are shared by both contracting parties (Usmani, 2002; Dar and Presley, 2003). The key element is that both parties—banks and entrepreneurs—provide capital and share profits. Profits of the projects are shared by prearranged agreement, not necessarily in proportion to capital. The return of investor (bank) is, thus, not guaranteed and fixed. In case of losses, both parties share in proportion of capital.

The first element of a Musharakah contract is that both parties contribute capital investment, and profits are shared by pre-arranged agreement, not necessarily in proportion to their invested capital. In case of loss, both parties share in proportion to their capital contribution.

The second element of a Musharakah contract is that both parties share and control the managements of the investment. Thus, in financing investment under the 'Musharakah' contract, Islamic banks exercise its right to examine investment records and to supervise the management of the enterprise.

¹ The Quran prohibits "riba" which is usury. Interest is interpreted as "usury" by most of the Islamic scholars.

² Please see Samad, Cook and Gardner, 2005 for detail

The third element of the Musharakah is that liability is unlimited. “Therefore, each partner is fully liable for the actions and commitments of the other in financial matters” (Maniam *et al.*, 2000).

Mudaraba’ (trust financing):

Under the Mudaraba contract, one party (investor) provides capital (maal) for a project and the other party (entrepreneur) provides labor to run the project. Profits and losses are shared by both parties. The profit and Loss Sharing (PLS) mode is a key feature of Islamic Banks (Farooq, 2007), Samad *et al.* (2005). In case of profits both the investor and entrepreneur share the reward of the project. Profits are shared by both based on pre-agreed arrangements. In case of failure of the projects there are losses and all financial loss is borne by the capitalist and the entrepreneur loses his labour (Iqbal and Molyneux, 2005). Risk is fairly distributed in IFIs. Investor (supplying capital) loses capital and entrepreneur (providing labor) loses his entire labor.

Under a Mudaraba contract, the two parties, the financier (supplier of funds) and the entrepreneur (trustee of the venture), share profits according to the agreed-upon profit and loss sharing (PLS) ratio.

The first key element of a Mudaraba contract is that the return is not guaranteed to the lender. This is in direct contrast to conventional interest-based lending/financing. In interest-based lending, a loan is not contingent upon profit or loss outcome of the entrepreneur, and is normally secured by collateral. Thus, any losses must be borne by the debtor, not the lender.

The second key element of a Mudarabah contract concerns losses that may arise from the business venture. “The financier or investor is not liable for losses beyond the capital he has contributed, and the entrepreneur or trustee does not share in financial losses except for the loss of his time and efforts” (Maniam *et al.*, 2000).

The third element of a Mudaraba contract is that a financier i.e. Islamic bank has no control over the management of the business venture undertaken by the entrepreneur or trustee.

Murabaha (Cost plus profit margin).

Mudarabah is similar to conventional trade financing where the Islamic bank finances the purchase. A buyer of a product approaches the bank for financing the product. The bank buys the product at the market price and sells the product to the buyer (borrower) at a mark-up price. The mark-up price is the market price plus the cost of transaction. The cost of transaction is the profit of the bank. The critiques of Islamic banks say the cost of transaction is exactly equal to the current interest rate. The interest characteristics of Murabaha are unlike that of conventional bank trade financing, the ownership and the title of the product remain in the hands of the bank until payment is complete. It is a popular substitute for interest-based conventional trade financing (Josh, 1997). From an economic point of view, Murabahah financing and interest-based trade financing appear quite similar except in the contractual features.

Third, Gambling is prohibited in Islam. The risk of investment without the probability of quantifiable measurement is equivalent to gambling and is, therefore, considered gambling.

Fourth, Zakah is an important characteristic of Islamic bank. Zakah is an obligatory poor due. It is one of five pillars of Islam and an integral part not only for an individual Muslim but also for Islamic Financial Institutions (IFIs). IFIs are obligated to pay “Zakah” from its profits to the poor towards a establishing “just and equitable” society. Zakah is paid in addition to the payment of corporate tax.

Fifth, “Qard-hasan” is benevolent financing. It is repeatedly emphasized in the Hadith and the Quran. Support the needy and feed the poor—is the basic message of Islam. ‘Spending out of what God has provided’ has been frequently instructed in the Quran. The “Qard-al-hasan (benevolent) financing is a cornerstone of Islamic finance” (Samad *et al.*, 2005). IFIs are expected to practice and enhance “Qard-hasan” in the society.

2.2. Conventional Banks

Conventional banks are interest based banks and are centuries old. Interest is the life and blood of conventional banks. They charge interests and fees for transactions. They charge interest when they are lending money and pay interest when they are mobilizing deposits or borrowing money. In both lending and borrowing, they charge interests which are fixed. The charging of fixed interest during the contract period is the key feature of the conventional banks and constitutes the main source of their profits.

Risk sharing in investment is one-sided in the conventional banking system. Borrowers bear the risk of investments. Unlike the profits and loss sharing mode of the Islamic banks, conventional banks, by fixing the interest, do not share the risk of income. Income is guaranteed in the conventional banking system whether the investments financed by the banks generate enough profits or fail.

3. SURVEY OF LITERATURE

There are studies dealing with conventional banks’ interest income and interest expenses. Those studies mainly dealt with net interest margins. Sounders and Liliana (2000) examined the determinants of net interest margins (NIM) of six European countries during the period 1988-1995. He found that bank payment of implicit interest on deposits, holding of noninterest bearing reserves with the central bank, and capital (to insulate credit risk) are positively related to NIM.

Claeyes and Vannet (2008) studied the determinants of NIM in the Central and Eastern European countries (CEEC) during 1994-2001. They found that NIM is negatively related to bank efficiency and competitive market conditions. That is, the higher NIM is related to low operational efficiency and non-competitive market conditions. Their study provided support in favor of the structure-conduct-performance hypothesis. Bank capital was positively related to NIM.

Valverde and Francisco (2007) studied the NIM determinants of the European banks during 1994-2001. They found that the market power and bank risk parameters are significant factors for NIM. The risk parameters such as credit risk, liquidity risk, and bank capital adequacy are positively related to NIM.

(Fungacova and Poghosyan, 2011) examined the determinants of NIM in the Russian banking sector with an emphasis on the bank ownership structure during the period 1999-2007. They found that the impact of NIM determinants varied across state-owned, foreign-owned, and domestic private banks. They found that the high NIM was positively related to market concentration and was negatively related to credit risk. The negative relation holds only for domestic private banks. The main message of their study was that bank ownership was an important determinant for NIM in Russia.

Maudasm and Guevara (2004) analyzed the NIM in the European banking sectors of five countries (Germany, France, UK, Italy, and Spain) during the period 1993-2000. They found NIM was positively related to market structure (Lerner Index and Herfindahl Index), interest rate risk, credit risk, and average operational costs.

Demirguc-Kunt and Huizinaga (1999) examined the determinants of net interest margins of 80 countries during the period 1988-1995. The main findings of their studies were that the NIM was determined by a host of factors such as bank specific factors, regulatory factors, macroeconomic variables, and banks' attitude toward risk. Assets to domestic products ratio and market concentration were negatively related to NIM.

Similarly, there are studies dealing with Islamic banks' profitability issues. Those studies mainly dealt with Islamic banks' performance and Islamic Vis-à-vis conventional banks comparative performances. Samad (1999; 2004), Samad and Hassan (2000), Samad *et al.* (2005), Basir (2003), Sufian and Majid (2006), and Safiullah (2011) studied comparative performance of Islamic banks. None of these studies dealt with noninterest expenses.

The survey of the literature shows that there is no study that dealt with the non-interest income/expenses issues of conventional as well as Islamic bank and also there is no evidence of comparative study of non-interest expenses between conventional and Islamic bank. Therefore, this study aims to provide a contribution in the banking literature.

4. DATA AND METHODOLOGY

4.1. Data

Data for non-interest expenses and total assets is obtained from the annual report of each bank's web side. Non-interest expense as percentage of total assets is calculated by the author. The descriptive statistics of variable is reported in Table 1.

4.2. Methodology

The t-test for mean noninterest expense is performed for determining whether there is a significant difference in non-interest (fee) expenses between Islamic and conventional banks. The null hypothesis for t-test is tested against the alternative hypothesis.

Null hypothesis, $H_0: \mu_d = (\mu_{\text{noniComb}} - \mu_{\text{noniISb}}) = 0$: There is no difference in non-interest expenses between conventional bank and Islamic bank. Where μ_d is difference between conventional banks' mean noninterest expenses, μ_{noniComb} and Islamic banks' mean noninterest expense, μ_{noniISb} .

Alternative hypothesis, $H_a : \mu_d = (\mu_{\text{noniComb}} - \mu_{\text{noniSb}}) \neq 0$: There is a difference in noninterest expenses between the conventional banks and Islamic banks. Non-interest expenses are not the same for both banks

The median test for noninterest expense is performed in determining whether there is significant difference in non-interest (fee) expenses between Islamic and conventional banks. The null hypothesis of non-parametric test, median test, is tested as:

Null hypothesis, H_0 : $\text{Med}_{\text{noniComb}} = \text{Med}_{\text{noniSb}}$: There is no difference in median noninterest expenses between conventional banks and Islamic banks. Where $\text{Med}_{\text{noniComb}}$ and $\text{Med}_{\text{noniSb}}$ are median noninterest expenses of conventional banks and Islamic banks respectively.

Alternative hypothesis, H_a : $\text{med}_{\text{noniComb}} \neq \text{Med}_{\text{noniSb}}$: There is a difference in median expenses between them.

First, the data series is to be tested for their normal distribution using Jarque Bera. The test of the normal distribution determines whether to use parametric test or non-parametric test. Parametric t-test/ANOVA test is performed if both series (non-interest expense of conventional bank and the Islamic banks) are normally distributed. Non-parametric test i.e. median test such as Mann-Whitney/Kruskal-Wallis K test tests is performed when a data series is not normally distributed.

The probability of Jarque Bera, 0.0000, in Table 1, rejects the null hypothesis that the series for noninterest expenses of conventional banks is normally distributed. That is, the series is not normally distributed. The rejection of normal distributions provides the appropriateness of non-parametric tests i.e. median tests. On the other hand, the high p-value, 0.512, of the Jarque-Bera for Islamic bank series fails to reject the null hypothesis of normal distribution. That is, Islamic bank series $\sim N(\mu=0, \sigma)$. The failure to reject the normal distribution suggests the appropriateness of using parametric tests. Thus, the paper uses both parametric tests and nonparametric tests.

Table-1. Descriptive Statistics of noninterest expenses for conventional and Islamic Banks

Conventional Banks		Islamic banks	
Mean	0.017	Mean	0.012
Median	0.011	Median	0.012
Maximum	0.163	Maximum	0.027
Minimum	0.0006	Minimum	0.0004
Std. Dev	0.02	Std. Dev	0.009
Jarque Bera	943.38	Jarque Bera	0.512
Probability	0.0000	Probability	0.777
Observation	34	Observation	7

5. EMPIRICAL RESULTS

Results of both parametric test (t-test) and non-parametric test (median) are provided in Table 2 and Table 3 respectively.

Table-2. Equality of Mean Test for Fee Expenses between Conventional and Islamic Banks

Method	df	Value	Probability	
t-test	39	0.467649	0.6426	
Satterthwaite-Welch t-test*	26.96919	0.819723	0.4196	
Anova F-test	(1, 39)	0.218696	0.6426	
Welch F-test*	(1, 26.9692)	0.671946	0.4196	
*Test allows for unequal cell variances				
Analysis of Variance				
Source of Variation	df	Sum of Sq.	Mean Sq.	
Between	1	0.000137	0.000137	
Within	39	0.024419	0.000626	
Total	40	0.024556	0.000614	
Category Statistics				
Variable	Count	Mean	Std. Dev.	Std. Err. of Mean
NONITAC	34	0.017561	0.026876	0.004609
NONITAIS	7	0.012704	0.009850	0.003723
All	41	0.016731	0.024777	0.003870

The results, in Table 2, show that the mean fee expenses of conventional banks (NONITAC) and Islamic banks (NONITAIS) are 1.7 percent and 1.2 percent respectively.

When the tests are performed to determine whether the mean expenses of conventional banks, 1.7 percent, are different from the mean expenses of Islamic banks, 1.2 percent, results of all parametric tests—t-test, Satterthwaite-Welch t-test, Anova-F test, and Welch tests—show no significant difference. The high p-values associated with all methods of test suggest that the null hypothesis of the equality of mean between the conventional banks and the Islamic banks cannot be rejected.

Table-3. Results of Median test for Conventional Banks and Islamic Banks Noninterest Expense

Test for Equality of Medians Between Series					
Date: 10/31/13 Time: 12:59					
Sample: 1 35					
Included observations: 35					
Method	df	Value	Probability		
Wilcoxon/Mann-Whitney		0.225212	0.8218		
Wilcoxon/Mann-Whitney (tie-adj.)		0.225212	0.8218		
Med. Chi-square	1	0.236255	0.6269		
Adj. Med. Chi-square	1	0.005025	0.9435		
Kruskal-Wallis	1	0.058824	0.8084		
Kruskal-Wallis (tie-adj.)	1	0.058824	0.8084		
van der Waerden	1	0.235757	0.6273		
Category Statistics					
> Overall					
Variable	Count	Median	Median	Mean Rank	Mean Score
NONI _{Conb}	34	0.011400	16	21.20588	0.032121
NONI _{ISb}	7	0.012048	4	20.00000	-0.156018
All	41	0.011464	20	21.00000	-2.17E-17

The high probability associated with Wilcoxon/Mann-Whitney and Kruskal-Wallis, as well the mean rank values, in Table 3, suggest that the null hypothesis of no difference between conventional banks and Islamic banks noninterest expenses cannot be rejected. That is, there is not enough statistical evidence that the fee charges of the conventional banks and the Islamic banks are different.

One plausible explanation for the equality of mean fee expenses between the conventional banks and the Islamic banks is that the banking market is very competitive in Bangladesh. In a highly competitive environment, banks, whether they are Islamic banks or conventional banks, simply lose market shares if it charges higher fee expenses than others'. The result of the Herfindahl-Hirschman Index, in Table 4, substantiates the claim that the banking industry of Bangladesh is

Table-4. HHI Estimate for Deposit and Loans Market in Bangladesh

HHI for Market	HHI₄	HHI₈	HHI₁₂
HHI loan & investment	274.18	317.76	351.55
HHI Deposit	329.86	368.91	400.55

Based on US Department of Justice Merger Guidelines of 1982, "unconcentrated" market is defined when the HHI Index is less than 1,000. Table 3 shows that the market concentration in both deposits and loans market is even less than 500 which suggest that both deposits and loans markets of Bangladesh are highly competitive.

6. CONCLUSION

The comparison of noninterest expenses between the conventional banks and Islamic banks of Bangladesh is tested by t-test and nonparametric tests. Results of both parametric and nonparametric tests provided in Table 2 and Table 3 respectively suggest that there is no significant difference in noninterest expenses between conventional banks and Islamic banks. However, this conclusion cannot be generalized based on the study of just one country and on the basis of seven Islamic banks.

The competitive banking market of Bangladesh is an important factor for the equality of mean fee charges between the conventional banks and the Islamic banks.

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