Banking Crisis: Empirical Evidence of Iranian Bankers

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Abstract

It is generally understood that well functioning banks and financial institutions help promote economic growth. That's why Iranian government is trying to play active role to promote economic growth through well established banking and financial system. This survey shows that after interference of Iranian government in banking sector the going concern of Iranian banks became sustainable. However, the interference raises higher level of inflation in Iranian economy.

Keywords: Bank crisis, Survival, Inflation, and Iran.

1. Introduction

Arthur Lewis, Alexander Gerschenkron, Gunnar Myrdal and several other prominent development economists writing in the 1950s and 1960s tended to agree that the state should play a key role in the banking sector; therefore it is essential that the government should play vital role in this area. Development banks are government-sponsored financial institutions concerned primarily with the provision of long-term capital to industry. These institutions are known to have played a crucial role in the rapid industrialization process (Gershenkron, 1952; Cameron, 1953; Diamond, 1957; Yasuda, 1993). Further, now a days it is widely accepted that well functioning financial systems can help promote economic growth, especially in developing and under developed countries (Rioja and Valev, 2004; Demetriades and Andrianova, 2004). However, there is a general perception that more recent development banks in the less developed counties have often failed to replicate the successes of earlier examples. Every government is supervisor of all economic sectors in a country, which by formulating rules and regulations supervises as well as monitors their services to improve economic conditions. Further, it is assumed that governments by analyzing economic conditions formulate the Acts that are helpful in reaching better economic conditions. However, sometimes those Acts do not contribute towards good health and getting good economic situation and resultantly, go far away from economic goals. In the developed countries due to suitable Banking Acts they are running the better economic condition rather than developing countries (Demetriades, 1999). The main goal of this paper is to see whether new Act of Iranian government on banking sector leads to good or bad economic conditions? The remainder of this paper is divided into: history of Iranian banks, review of related literature, research methodology, analyses and conclusion.

2. History of banking in Iran

La Porta et al. (2002) documents that government ownership of banks is pervasive worldwide; in 1995 state ownership in the banking industry around the world averaged about 41.6% percent (38.5% if we exclude former socialist countries). Mayer (1990) shows that bank financing is the main source of outside financing in all countries. Yet despite the prevalence of government-owned banks in many countries, the prominent role of bank financing, and the importance of efficient financial markets for growth, there is very little evidence on how government ownership affects bank lending.

Banking operations had been carried out in Iran by temples and princes before the advent of Achaemenid dynasty by government. In that period, trade boomed in the country, thus giving a boost to banking. Before a bank in its present form was established in the country, banking operations had been carried out in traditional forms in the form of money changing. Money changing began to decline with the establishment of New East Bank, an originally British owned bank in the country in 1850. Bank Sepah was the first bank to be established with Iranian capitals in 1925 under the name of Bank Pahlavi Qoshun, in order to handle the financial affairs of the military personnel and set up their retirement fund. The primary capital of the bank was 388,395 Tomans. In the spring of 1979, all Iranian banks were nationalized and banking laws changed with the approval of the new interest free Islamic banking regulations. Simultaneous with promotion of trade and business in the country, more people chose money changing as their occupation (Salehi et al, 2008).

Following a boost in trade and use of bank notes and coins in trade during the Parthian and Sassanian eras, exchange of coins and hard currencies began in the country. Some people also managed to specialize in determining the purity of coins. Bank notes and gold coins were first used in the country following the conquest of Lidi by Achaemenid king Darius in 516 B.C. At that time, a gold coin called Derick was minted as the Iranian currency. During the Parthian and Sassanian eras, both Iranian and foreign coins were used in trade in the country. However, with the advent of Islam in Iran, money changing and use of bank notes and coins in trade faced stagnation because the new religion forbade interest in dealing. In the course of Mongol rule over Iran, a bank note which was an imitation of Chinese bank note was put in circulation. The bank notes, called Chav bore the picture and name of Keikhatu. On one side of the bank notes there was the following sentence: "Anybody who does not Besides Chav, other bank notes were used for a certain period of time in other Iranian cities and then got out of circulation. Before the printing of first bank notes by the Bank Shahanshahi (Imperial Bank), a kind of credit card called Bijak had been issued by money dealers. As mentioned before, money changing got out of fashion with the advent of Islam under which usury is strictly forbidden.

The New East Bank established in 1850 was in fact the first banking institute in its present form established in Iran. It laid the foundation of banking operations in the country. It was a British bank whose headquarter was in London. The bank was established by the British without receiving any concession from the Iranian government. The New East Bank allowed individuals to open accounts, deposit their money with the bank and draw cheques. It was at this time that people began to draw checks in their dealings. In order to compete with money dealers, the bank paid interest on the fixed deposits and current accounts of its clients. The head office of the bank in Tehran issued five `qeran' bank notes in the form of drafts. According to a concession granted by the Iranian government to Baron Julius De Reuter in 1885, Bank Shahanshahi (Imperial Bank) was established. This bank purchased the properties and assets of the New East Bank, thus putting an end to the banking operations of the former. The activities of Bank Shahanshahi ranged from trade transactions, printing bank notes, and serving as the treasurer of the Iranian government at home and abroad in return for piecework wage. In return to this concession, Reuter obliged to pay six percent of the annual net income of the bank, providing that the sum should not be less than 4,000 pounds, and 16 percent of incomes from other concessions to the Iranian government. The legal center of the bank based in London was subject to the British laws with its activities were centered in Tehran.

In 1209 (lunar hejira), the right of printing bank notes was purchased from Bank Shahanshahi for a sum of 200,000 pounds and ceded to the Bank Melli of Iran. Bank Shahanshahi continued its activities until 1948 when its name was changed into Bank of Britain in Iran and Middle East. The activities of the bank continued until 1952. In 1269 (l.h.), Jacquet Polyakov, a Russian national received a concession from the then government of Iran for establishment of Bank Esteqrazi for 75 year. Besides, banking and mortgage operations, the bank had an exclusive right of public auction. In 1898 the Tzarist government of Russia bought all shares of the bank for its political ends. Under a contract signed with Iran, the bank was transferred to the Iranian government in 1920. The bank continued its activities under the name of Bank Iran until 1933 when it was incorporated into the Bank Keshavarzi (Agriculture Bank).

Bank Sepah was the first bank to be established in Iran in 1925 and opened its branches in major Iranian cities; the bank began carrying financial operations such as opening of current accounts and transfer of money across the country. The Iran-Russia Bank was formed by the government of the former Soviet Union in 1926 with an aim of facilitating trade exchanges between the two countries. The headquarters of the bank was in Tehran with some branches being inaugurated in northern parts of the country. The bank dealt with financial affairs of institutes affiliated to the government of the former Soviet Union and trade exchanges between the two countries. The activities of this bank, which were subject to Iranian banking regulations, continued until 1979. In that year, this bank along with 27 other state-owned or private banks was nationalized under a decision approved by the Revolutionary Council of the Islamic Republic of Iran.

The proposal to establish a national Iranian bank was first offered by a big money dealer to Qajar king Nasereddin Shah before the Constitutional Revolution. But the Qajar king did not pay much attention to the proposal. However, with the establishment of constitutional rule in the country, the idea of setting up a national Iranian bank in order to reduce political and economic influence of foreigners gained strength and at last in December 1906 the establishment of the bank was announced and its articles of association compiled.

In April 1927, the Iranian Parliament gave final approval to the law allowing the establishment of Bank Melli of Iran. But, due to some problems, the Cabinet ministers and the parliament's financial commission approved the articles of association of the bank in the spring of 1928. The Central Bank of Iran was established in 1928, tasked with trade activities and other operations (acting as the treasurer of the government, printing bank notes, enforcing monetary and financial policies and so on). The duties of the CBI included making transactions on behalf of the government, controlling trade banks, determining supply of money, foreign exchange protective measures and so on.

In June 1979, Iranian banks were nationalized and banking regulations changed with the approval of the Islamic banking law (interest free), and the role of banks in accelerating trade deals, rendering services to clients, collecting deposits, offering credits to applicants on the basis of the CBI's policies and so on was strengthened. In short now a days there are currently around seventeen commercial banks in Iran, of which eleven are state-owned and six are privately owned. All the banks must follow Islamic banking principles whereby usury is forbidden and, rather than average interest rates (AIRs). Profit rates are set on deposits and expected rates of profit on facilities on loans. In terms of both assets and capital, the banking sector is dominated by Bank Melli Iran (National Bank of Iran). In recent years, six privately owned banks, Bank Kafarin, Bank Parsian, Bank Eqtesad-e-Novin Bank Saman, Bank Pasargad and Bank Sarmaye have commenced operations in Iran for the first time since the nationalization of the Iranian banking sector in 1952. The below table shows, the types and numbers of Iranian banks (Salehi and Abedini, 2008).

Table No.1 Types and Numbers of Iranian Banks

GOVERNMENT BANKS		**PRIVATE BANKS**
Commercial Banks	**Specialized Banks**	**Commercial Banks**
Name of Banks	Name of Banks	Name of Banks
Tejarat	Tosehsaderat	Egtesadnovin
Refah	Sanat va madan	Persian
Sepah	Keshavarzi	Pasargad
Postbank	Maskan	Saman
Saderat	----	Sarmayeh
Melat	----	Karafarin
Melli	----	----
Total 7	4	6

3. Review of Literature

While most economists would agree that market failures in the banking system warrant some degree of government intervention (Salehi and Azary, 2008), the specific nature of this intervention and, in particular, the dilemma between regulation and contracting of private agents, and direct state ownership, is less likely to generate consensus. Under what conditions would be state ownership justified? However, there is much literature regarding the intervention on banking sector. Therefore, this paper briefly explains literature related to banking crises and failures.

Different economic schools of thought view financial crises in a different perspective. Monetarists (e.g., Friedman & Schwartz, 1963) have linked financial crises with banking panics. This school of thought stresses the importance of banking panics because bank crises are a major source of contractions in the money supply. According to this view, contractions in the money supply in turn may lead to severe contractions in economic activity, as observed both in the United States and abroad. Another group of influential scholars (e.g., Kindelberger, 1978) takes a much broader definition of what constitutes a real financial crisis. In their view, financial crises involve one or more of the following elements: sharp decline in asset prices; failure of both large financial and non-financial institutions; deflation or disinflation; and disruption in foreign exchange markets.

In an empirical study, Demirguc-Kunt and Detragiache (1997) discuss the causes of banking crises in depth and try to determine the features of the economic environment that prepare the stage for such a system-wide fragility. They estimate the probability of a systemic crisis econometrically, employing a multivariate logit model on data from a large panel of countries, both industrial and developing, for the period 1980–1994. Countries that never experienced banking problems are also included in the panel as controls. The authors find that crises tend to happen in a weak macroeconomic environment characterized by slow GDP growth and high inflation. When these effects are controlled for, neither the rate of currency neither depreciation nor the fiscal deficit is significant. In addition, vulnerability to sudden capital outflows, low liquidity in the banking sector, a high share of credit to the private sector, and past credit growth are found to be associated with a higher probability of banking crisis. Moreover, their results suggest that the presence of explicit deposit insurance is strongly associated with increased vulnerability in the banking sector; implying that moral hazard has a major role in inducing risk-taking behavior leading to the crisis. Using estimates of the cost of banking crises from Caprio and Klingebiel (1996), the authors also test whether the set of explanatory variables used in the logit model can also account for the severity of each crisis. They find that most of the same variables that tend to make crises more likely also tend to make them more costly.

4. Objectives of Study and Research Methodology

Since, the main objective of this survey is to determine the relationship between inflation rates and loans interest rates for long term survival of Iranian banks, the useful data (inflation) was collected from Iranian economic reports as well as Iranian Finance Ministry Reports during the 2000 to 2007. Other useful data (rate, deposit rates and interest rates) was collected from 11 Iranian government banks and 6 private banks' annual reports for the same period. One of the most popular statistical tools is correlation coefficient is employed in this survey for determining the relationships of three above mentioned factors.

5. The Results of the Study

As it is seen in the table No.2 the Average Interest Rates (AIR) with Average Deposit Rates (ADR) is compared at government banks in Iran. The different between these two is Margin Rate (MR). The MRs are positive numbers from the past up to the year 2005. But the MRs have been negative numbers after this year up to now (2007). During the year 2005 interferences were started by government. As it is shown in the table No.1 the MRs are 2.68%, 3.70%, 2.70%, 2.40%, 2.20%, and 1.80% from the year 2000 up to the year 2005 respectively. This factor is -0.13% in the year 2006 and -1.93% in the year 2007.

Table No.2 The Margin Rates of Government Banks

Rates / Years	Average Interest Rates (AIR)	Average Deposit Rates (ADR)	Margin Rates (MR)
2000	17.75	15.07	2.68
2001	17.70	14.00	3.70
2002	16.70	14.00	2.70
2003	16.40	14.00	2.40
2004	16.20	14.00	2.20
2005	15.80	14.00	1.80
2006	13.80	13.93	-0.13
2007	12.00	13.93	-1.93

It is evident that the positive MRs are essential for banking and other commercial entities. Therefore if negative MRs prevail in banking industry as it happened in two years (2006 and 2007), industry may get big problems about its assumption of going concern. The negative MRs threat the continuity principle in this group of government banks.

In this investigation it is found that although negative MRs for two successively years (2006 and 2007), the government banks in Iran showed the profit from operation in their financial statements. It was sufficient to consider deeper investigation about these profits. So the authors investigated banks' manner in preparing of financial statements with particular pay attention to accounting policies.

It is interesting to note that the authors found some cases on the way of preparing financial statements that may be arranged in the following cases:

(1) Large parts of the interest incomes were related to the previous loan contracts between banks and customers which had high AIRs. In other words, large amounts of bank profits were from the loan contracts whose MRs were positive. Because the AIRs of loans were higher than the ADRs for all the years before these two years.

(2) According to the accounting policies in Iranian banks, the recognition of revenues from loans were recorded before loan principals, i.e. when customers pay the initial installments of the loans, bank accountants record most of these amounts as revenues not as loan principals. The formula used in calculating principal amount of loan is:

$$P_i = P_t \frac{K(K-1)}{N(N-1)}$$

Where;

P_i= the profit (interest-revenue) of the installment (i)

P_t = the total interest revenue of the loans

K= the number of unpaid installment (immaturity installment)

N= the number of whole installments.

With regard to the above mentioned formula, for example there is a loan with $1000 as principal amount with 10 per cent interest and repaid period 120 months. To account revenue of the first installment of this loan it should be record 12.4 $ as interest revenue and just $ 0.1 as loan principal. This continues with slow gradual in next installments. Further, it is recorded $ 12.2 as interest revenue and $ 0.3 as principal for second installment. Therefore, it is clear that recognized profit is much more than loan principal for first annuities. Owing to this accounting policy and case No.1 parts of the profit have showed in financial statements were the interest revenue from loans which were paid to costumers in recent years. These loans have paid with high AIRs. Therefore, this policy helps banks to showing the profit instead of loss. But it should not be unnoticed that this way of accounting record was against conservatism principle and it was also contrary to realization and matching principles.

In recent years the accounting policies on the recognition of interest revenues changed from cash basis to accrual basis. This caused the banks to show some big amounts as accrual interest from accruals adjusting in the end of fiscal year. With regard to the above mentioned case if this condition (negative MRs) continues in few years the going concern position may get some serious problems and bankruptcy is not far form the expectation. This problem may better appear when it is known that in future the recognition revenues will be finished from the previous contracts that have high rate. After these the government banks cannot practice like now. They cannot show the interest revenues from previous loans, also the accrual accounting function in practice will be better than now. Therefore, interest revenues of government banks decrease and they have net loss in the income statements. Bankruptcy is a fact and it happens when a company cannot go away from losses. Thus, going concern problem appears in such case that losses stand instead profits for banking operation in long time. So, that time compensation is so difficult than un-interference in banking operation by government. This description about government banks was also correct for private banks. It is shown in Table No.3 that the MRs are positive before the government interferences and after that the MRs became negative.

Table No.3 The Margin Rates for Private Banks

Rates / Years	Average Interest Rates (AIR)	Average Deposit Rates (ADR)	Margin Rates (MR)
2004	26.00	17.50	8.50
2005	25.50	18.33	7.17
2006	17.00	17.37	-0.37
2007	12.00	14.50	-2.50

It is interesting to note, that the accounting policies used in private banks were similar to the accounting policies in government banks. Therefore, the cases (3 above mentioned cases) were also correct for these types of banks.

3.1 Comparison between loans interest rates and inflation rates

It is common that AIRs were a little higher than Inflation Rates (IR) in healthy economies. It is showed at Table No.3 this convention was correct in Iran's economy before the year 2005 (the year that government changed the loan AIR by government order).

Table No.4 The Margin Safeties for Government Banks

Rates / Years	Average Interest Rates (AIR)	Inflation Rates (IR)	Margin Safeties
2000	17.75	21.00	-3.25
2001	17.70	19.00	-1.30
2002	16.70	17.00	-0.30
2003	16.40	15.30	1.10
2004	16.20	16.40	-0.20
2005	15.80	15.50	0.30
2006	13.80	13.50	0.30
2007	12.00	15.80	-3.80

Correlation coefficient is employed for grasping the relationship between IRs and loan AIRs. There was a positive meaningful relationship between loans AIRs and IRs for the period from 2000 up to 2005. The correlation coefficient was +92%. But after the year 2005, the Iranian government claimed minimizing inflation rate and improving direct investment and forced the banks to reduce the loans AIRs. Table No. 3 showed that the IRs were much higher than the AIRs for the years 2006 and 2007. The correlation coefficient between IRs and AIRs was negative. That means it was against to the health of the economy. Therefore, the margin safety from inflation for Iranian banks has been removed by government policy. Besides, the loan AIRs were lower than ADRs, the loan AIRs were lower than IRs also. So, not only banks' profits from loan AIRs after ADRs have decreased but also banks' expenses (operation and non-operation) have increased due to IRs. The results of these two problems put Iranian banks into a bad situation of going concern problems. The above mentioned problem is correct for private banks as well as government banks. The same has been shown in Table No.5 that the cases (3 above mentioned cases) were also correct for private type of banks.

Table No.5 The Margin Safeties for Private Banks

Rates / Years	Average Interest Rates (AIR)	Inflation Rates (IR)	Margin Safeties
2004	26.00	16.40	9.60
2005	25.50	15.50	10.00
2006	17.00	13.50	3.50
2007	12.00	15.80	-3.80

6. Conclusion

Economical development is the hallmark of any society. Any country around the world can try to reach this economic utopia. One of the most important sectors that play major role for grasping that condition is bank. According to this survey the Iranian government rather encourages banking sector to enlarge their services, by scanting inexpert acts putting them in big trouble; the outcome of this situation not only affects banking sector, but also damages the economic conditions. In this paper the authors come to the conclusion that in this economic condition we are very far from our economic utopia. For covering this gap the government should take professional actions; otherwise at first our banks would be bankrupt and then, the whole economy.

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