Investigating the banking system's competitiveness effect on the financial stability in Iran

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Abstract: Nowadays the economy of the countries is affected by the banking industry. On the one hand, banks as an enterprise collect deposits from society, and on the other hand grant financial facilities to current activities. Competitiveness in the banking system along with the development of financial stability could affect the economy, and would be of great help to policy-makers and economic planners to achieve economic prosperity of the country. Present paper investigated the relationship between the competitiveness of the banking system, the ratio of doubtful accounts to financial properties, and net interest margin to financial stability among eight banks in Iran using econometric panel data from 1385 to 1391. The results indicated that all the model's independent variables had significant relationship with financial stability. With respect to the coefficients of the model, the relationship between competitiveness and financial stability was positive and the relationship of doubtful accounts and earnings with financial stability was negative. In other words, increase in competitiveness between the banks would lead to financial stability and banks as an effective financial firms could provide economic growth of the country.

Introduction

One of the important issues that attracted the attention of many scholars and policymakers is financial stability to which policy makers and economists paid more attention since the financial crises in Latin America, Southeast Asia, Russia, and Turkey at the end of last decade. One of the strategies of financial stability which can be stated is adopting preventive measures to tackle systemic risks in the financial sector and developing strength in financial institutes to cut the costs of financial crisis. Gary Schinasi (2004) believed that financial stability would not let the main elements of the financial system enter in a series of imbalances that periodically threaten the economic efficiency. He considered the financial stability in the economy as the necessary condition to assess, identify, and correctly manage financial risks (credit, liquidity, and market) in order to maximize the efficiency of the economy. In general, the financial stability is a condition in which the systematic financial crisis does not threaten macroeconomic stability. The financial crisis is known as a sudden and rapid change in all or most of the financial indicators such as assets prices (securities, shares, real estate, and land), bankruptcy, and collapse of financial institutions. Currently banks, in the economic systems of the world, are accounted as one of the largest pathology center of financial stability and considered effective on economic security of financial intermediaries and are important elements of financial structures, as they constitute the main focus of financial stability. Therefore, investigating the strength of banks' balance sheets in the face of risks that systematically endanger banks' resources and costs management is one of the common ways to assess the stability of a financial system (Abdi Rad, M., & Mirzaee, I., 1388). Financial stability in a financial system occurs when the following three conditions achieved:

1. The ability to efficiently allocate economic resources and power efficiency of making other economic processes (economic growth, social welfare, and the density of the assets) should be presented. 2. Appropriate management should be taken regarding estimating pricing and allocation and management of financial risks. 3. There should be ability to run aforementioned cases even in exposing foreign crises (Gary Schinasi, 2004).

This article attempted to demonstrate that the competitiveness of the banking system had a significant and positive relationship on financial stability through appropriate management, and having market power, innovation, and ability to influence prices. Maximizing the efficiency and stability and developing diversity in investment can be considered as a positive effect of competitive banking system.

Theoretical literature

A) competition

Adam Smith (1790-1723) stated that competition is an activity and movement which only happens in a state of "imbalance" when the equality of supply and demand breaks down. When a supply excess happens,

suppliers compete with each other to impose it on others and vice versa when supply decreases, applicants compete to allocate available goods to themselves. Based on Smith point of view thus competition components can be summarized as follows: 1. freedom of competition is the logical consequence of natural freedom. 2. Private interests as individual's leading incentives force them to do things that the society is willing to reward them and the final result of it is the equality of supply and demand. 3. Individuals competition in using every opportunity to gain private interests lead these heterogeneous interests to the interests of society and the society continues its survival. Schumpeter (1950-1883) suggested that real competition would not take place among small firms producing the same goods, but it happens between the source firms and other firms. According to Schumpeter, initially an innovation occurs (creativity), makes a temporary monopoly, and brings exclusive interest, then this innovation distributes and exposes to new innovations which diminish exclusive interests (destruction) and this will continue (competitive process of creative destruction). Michael E. Porter (1990-1980) is one of the greatest theorists in the field of competitiveness and required strategies to compete by businesses. Porter is world famous for the concepts and topics such as strategy, competitive strategy, competitive advantage, value chain, and competitive advantage of nations and is considered as an influential thinker. One of the most significant models that he has presented is the five forces of competition including: customers, suppliers of the raw materials, potential competitors, and substitute goods. Impression and impact of these five factors on each other determines the nature and intensity of competition. Porter believed that all companies are looking for profit and the factor that determines the amount of profit is the intensity of competition. If the intensity of competition is identified, profitability will be determined too. Porter, doing research in 10 selected countries, presented an analytical model for assessing and ranking the competitiveness advantages of the world's countries, in a book named "The Competitive Advantage of Nations" and called it diamond model. He argued that the sustainability of competitive advantages of the countries at the industrial level are comparable with other countries by 6 factors of diamond model. This model was initially examined in 10 countries, eight developed and two developing countries, including Denmark, Germany, Italy, Japan, Korea, Singapore, Sweden, Switzerland, United Kingdom and United States of America. Diamond model is based on four factors: (1) internal factors, (2) demand conditions, (3) supporting industries, (4) strategy, structure and rivalry. These four factors mutually influence each

other and change in each one of them can be effective on all other factors. Rugmn and Cruz (1993) extended this framework to "Double Diamond". Porter and Miller (1985) believed that the impact of information technology on competition is vital from three aspects of: changing the industrial structure and the rules of competition, developing a competitive advantage through suggesting new ways to overcome rivals, and expanding businesses even through inside the company's present activities. Li (2000) suggested a descriptive model of performance by analysis of the competitiveness resources and considered it as the competitiveness index. He also introduced marketing, product innovation, production and development of human resources as the four effective factors on competitiveness. In their study, Moutinho and Philips (2002) focused on analyzing the perceptions of 58 managers from 14 branches of two Scottish banks in order to investigate the effect of planning methods variety on competitiveness, overall performance, effectiveness of strategic planning, and marketing. They concluded that effectiveness is effective under management methods and overall performance largely depends on long-term thinking and innovation. Long-term thinking also has a great effect on the effectiveness of strategic planning and emphasis on planning, budgeting, and controlling will have a great effect on the level of marketing effectiveness. In many experimental studies, a strong positive relationship between economic growth and competition in the banking industry has been confirmed (Jayaratne & Strahan, 1996; Levine, Loayza & Beck, 2000; Collender & Shaffer, 2003). The findings of some recent studies have shown that the effect of competition in the banking industry is not completely clear similar to the effect of competition in other industries (Claessen & Leaven, 2004). The European Union Committee like domestic policy makers of competition in European countries mainly uses market share and concentration levels (HHI principle) to detect competitive (Barbara & Claudia, 2009, p. 130).

B) **Financial stability**

Nowadays the problem of stability of banks has attracted the attention of many. Particularly the financial crisis of recent decades led the scholars and politicians to meticulously examine the stability of financial institutions especially banks. In this regard contagion perspective has shaped. Examining this issue, Allen and Gale (2000) stated that the contagion rate is under the influence of the interbank network structure. Perfect market is a structure in which each of the banks has a symmetrical relationship with each single bank. Imperfect structure is also a situation that any of the banks have relationships with banks around themselves. Allen and Gale argued that in a perfect market the effect of shock would transmit to all banks,

therefore the shock cost reduces for all individual areas but imperfect markets are very prone to contagion. If the number of banks and their areas of activity increase in an imperfect market, the probability of contagion will increase as opposed to the perfect structure situation. Thus, the combination of perfect and imperfect structure constitutes a structure that has the highest risk of contagion. Another perspective on this issue is the license value which indicates the ability of the bank to continue its activities in the future. Banks with more market power have more advantages and consequently have greater license value. Sihk and Hesi (2009) introduced an index based on the theory of license value to measure the stability of banks. This index is a dependent variable called z-score. One of the important features of this index is to show the stability rate clear, reasonable, and attributable. This index is attributable to both a bank which uses high risk-high-efficiency strategy and a bank that uses low risk-low efficiency strategy, provided that both strategies return to a fair rate of risk. Cihak and Hesse took z as the dependent variable and on which tested the effect of type of bank (Islamic and non-Islamic), macroeconomic variables, interaction of income deviation variable, and the effect of concentrated markets, and regulatory variables (central bank). They expressed the results of their research as follows: 1) loans ratio to the assets of large Islamic banks is normally more than that of large non-Islamic banks. 2) Islamic banks have more expenses to income ratio compared to non-Islamic banks as a result are less efficient than non-Islamic banks. 3) More income deviation increases z-score index in Islamic banks, thus stability increases by producing diversity in income sources. 4) The value of z-score index for big banks (Islamic or non-Islamic) is larger than small banks. 5) The control variable (central bank) has a positive effect on financial stability as a result it reduces instability. 6) Getting large adds to the financial stability of Islamic banks but on the other hand destabilizes large non-Islamic banks. 7) The deflation and boom periods have great impact on the stability and instability of banks.

In terms of financial stability and banking, the impact of competition on a special importance to the stability of banks.

The effect of competition on banks stability has specific significance in financial and banking stability issue. Some people believe that increasing the competition will lead to financial instability and have created the competition-fragility view. Some other believe that competition not only does not decrease financial stability but also increases it and have created the competition- stability view. The competition – fragility view was stated by Boyd and De Nicolo in 2005 and for this reason it was known as

BDN theory. They suggested that market power might destabilize the banking system and might be harmful for financial stability. They also pointed out that apart from banks, borrowers select the risk of their investments which were taken with financed bank loan. The behavior of borrowers depends on the loan rates and other loan contract terms. Generally borrowers determine project risk with regard to interest rate set by the Bank. Increase in concentration or decrease in competition among banks in the loan market, however, lead to applying higher interest rates on commercial loans. Therefore the more competition reduced, the more rent banks would gain through setting higher interest rates.

In the face of higher interest rates, optimally borrowers choose high-risk projects and maximize their risk of bankruptcy. The set high interest rates tighten loan repayments and increase the borrowers' incentive to move to more risky projects to offset loan high rates. The results of this practice would increase the risk of company default and consequently the higher the probability of bankruptcy loans to the Non-Current Receivables and as a result it would lead to higher bankruptcy risk and further instability. Ultimately, they concluded that there was a positive relationship between concentration and bank fragility.

Some of the most important challenges of the banking system in the current economic situation of country

1. The lack of stability in monetary policy: Banks are among the institutions which are directly affected by country's monetary policy. Short-term and unexplained changing procedures such as increasing the reference exchange rate and cuts in a short time, absence of stable policies such as lowering deposits interest rates and insistency on reducing it and releasing it at once and then applying the limitations and threatening the banks about deviating from the limitations specified or withdrawal from the bank account for the difference between the exchange rate in a certain transaction, imposing one sided withholding facilities, and taking offenses overdraft are all of the cases that face the possibility of drawing a clear picture of banking in the country with doubt. Therefore, central bank is required to provide a stable monetary policy at least for a year and if needed change this situation with regard to all the circumstances and by announced notice during the year. Taking stable monetary policies and considering all sectors in monetary policymaking including the interests of the banks, shareholders, depositors, and borrowers of their facilities is the necessity of banking activity in the harsh condition of sanctions. In this regard, a point that has received little attention is the consequences of distrust to banks whether in the capital market or in money market. Experience in

other countries has shown that the crisis would mainly start from the banks and if depositors or active capital market participants lose their confidence in banking sector, we must wait for the crisis in the economy.

2. Corporate banking: it is observed that in recent years various guilds and groups under the pretext of banks inefficiency in providing quality services to them directly request their own bank, and in many cases they managed to get license by Central bank. Although in accordance with existing regulations private banks of the country should be public and no natural or legal person and their dependents can own more than 10% of the shares of a bank, in practice with the use of certain ways in initial underwriting, staff members of a guild or an institution became the owner and shareholder of the bank and take the control of the bank. Poor supervision during underwriting and inaccuracy of central bank to the consequences of expansion of corporate banking led to development of these banks over the last two years, and this series still continues and guilds, corporations, and different groups think of establishing their own bank. The main reason to tend to corporate banking is that when different guilds, members and staff of a guild or institution encounter validation constraints in getting facilities from banking system, to get past this limitation on one hand and to get the possibility of less expensive resources and therefore taking cheaper loans on the other hand think of establishing their own bank. Experience has shown that corporate banks often would not be efficient banks and increase the risk of the banking system. Efficiency of the banking system and development of electronic banking for providing appropriate services to corporates and different institutions, greater transparency in giving micro-facilities and most importantly accurate monitoring on observing rules and regulations of the Central bank on granting facilities can be procedures to manage the challenges of corporate banking and lessen the interests of institutions and corporations to establish bank.

3. Non-Current Receivables: One of the challenges of the banking network is a problem called non-current facilities or referred to as demands. Loan interest rates growth, recession caused by the financial and economic crisis in the world, not to deepen and broaden capital market, and administrative bureaucracy in the administrative and judicial system of the country are all together the factors of increasing the volume of non-current receivables. In the past due to state banking this problem did not show up, but now with the arrival of private banks and the need to reserves for non-current receivables, banks saw their profitability at risk and paid more attention to this issue.

7. Supervision: the country banking system works within the three main rule "monetary and banking law" and "the administration of state-owned banks' bill" and "interest-free banking law". According to the monetary and banking law passed in July 1351, the Central bank of the Islamic Republic of Iran is the regulator of monetary and credit system of the country and supervisor of the banking system. In addition to the responsibility of monetary policymaking, in our country the Central bank as the supervisor of the banks is responsible of monitoring banks and financial institutes. On the other hand, capital market authority state is the securities and exchange organization that works under authority of the ministry of finance and economic affairs. The country's capital market itself acts within a separate legal framework. The above mentioned set of factors, as well as managers who are depended to government at the helm of the central bank on one hand, and the big banks on the other hand, the weakness of technology in the banking system of the country and the lack of comprehensive regulatory perspective as an observer expose banking supervision with difficulty.

4. Problems of obtaining facilities: lack of proper allocation of bank facilities on one hand, and facilities rate on the other hand has created problems. Some people have more access to facilities and sometimes get more facilities than their credibility due to the nature of their jobs or because of personal and impersonal relations. This has created some problems for banks for which increase in non-current receivables can be considered as one of the them.

Research background

A) Studies which have been done abroad

Bikker and Haaf (2000) investigated the relationship between centralization and competitiveness in selected countries inside and outside Europe using concentration ratio method to measure the concentration rate in the banking market and Panzar and Rosse method to measure the competition rate from 1986 to 1996. Results indicated that the banking market in the industrialized countries often have monopolistic competitive structure and just in some cases perfect competition state could not be ruled out. It also shows that the competitiveness of large banks is more than small banks and that the competitiveness of European banks is more than of American, Canadian, and Japanese countries as well. Moreover, a negative relationship was observed between the concentration rate and degree of competitiveness.

Claessens and leaven (2003) in examining the changes in the banking market competitiveness of 50 countries of the world using Panzar and Rosse model from1994 to 2001, concluded that banking system of these countries have higher competitiveness since the

rising entry of foreign banks and reducing functional limitations.

Bikker and Groeneveld (2004) through investigating the market structure and competition situation in the banking system of 6 Arabic countries which were members of Persian Gulf Cooperation Council using Panzar and Rosse model during the years 1993 to 2002, concluded that Kuwait, Saudi Arabia, and the United Arab Emirates' banks are in the situation of perfect competition and Bahrain and Qatar banks are in a monopolistic competitive situation. Oman monopolistic competitive situation in the banking market cannot be ruled out.

Cihak and Hesse (2008) reviewed 77 Islamic banks and 397 commercial banks from twenty countries over the years 1993 to 2004 using the combined least squares method. They stated that demonetization has significant effect on increasing the bank's risk, but the effects of growth economic and inflation on financial stability are not significant. They also divided banks into two groups of traditional and non-traditional banks and according to their size divided them into small and big banks, and came to the conclusion that the traditional big banks have higher degree of financial stability than large Islamic banks, and small Islamic banks have more financial stability than small traditional banks. Bamg Nam, Maria Pia, and Ji Wu (2010) in examining the effect of participation of foreign banks on the competitive structure of the Asia and Latin America's banking sector, using concentration indicators and Panzar and Rosse model from 1998 to 2008 concluded that the increased entry of foreign banks has increased the competition in the banking network of the host country. This effect is stronger when the presence of foreign banks in the host country is as newly established bank not as just buying bank shares of the host country.

Lim Kwang Kyu and Jin Q. Jeon (2013) investigated the relationship between competition and stability using a sample which contained two different types of banks: commercial banks and financial services institutions in South Korea. In this study, they used panel quarter data from 1999 to 2011, and concluded that there was a significant positive relationship between competition and stability in financial services institutions, but competition pressure in commercial banks significantly contributed to reducing stability.

Xiaoqing et al., (2013) examined the relationship between competition and stability using data from 14 countries in Asia and Pacific (China, Australia, Hong Kong, Indonesia, Japan, Korea, Malaysia, Pakistan, Philippines, Singapore, Sri Lanka, Taiwan, Thailand, and India) by applying generalized moments econometric method (GMM). They referred to the possibility of bankruptcy and bank stability index (Z-score index) as the dependent variable, the concentration of banking (the asset ratio of three large banks to total assets of that country banks), and competition (Lerner index) as independent variable, the size of the bank, the ratio of doubtful receivables to properties (LLP), net interest margin(NIM), and entry restriction as a control variable, as well as the crisis virtual variable for 2008 and 2009 (they took one to use crisis virtual variable for 2008 and 2009 and zero for other years). Results were expressed as follows: investigating the effect of concentration and competition on banking stability suggests that competition has significant and positive impact on the stability, while the concentration has negative impact on banking stability. Moreover examining the effect of concentration and competition on probability of bankruptcy demonstrates that there is a significant and negative relationship between competition and the possibility of bankruptcy, while the relationship between bank concentration and the possibility of bankruptcy is positive and significant. Also through investigating control variables it was identified that bank size has inverse relation to banking stability and smaller banks are more stable, tougher entry restrictions and reduced demands increases banking stability.

Adnan Kasman (2014) in reviewing bank competition and financial stability for 272 commercial banks from fifteen Latin American countries during 2001 to 2008 using Granger causality in dynamic panel came to the conclusion that there is a significant and positive relationship between competition and stability, therefore more competition leads to greater financial stability.

Model Analysis

In this study panel data for eight banks (Bank Meli, Maskan, industry and mining, Eghtesad Novin, Karafarin, Saman, and Sinai) of Iran's banking system were used which according to their experience of practice, ease of access to the financial statements, and presence and presenting services in the field of banking were selected consistent with technology advancement and the use of new services of the time interval from 1385 to 1391 after performing unit root tests and Pedroni co-integration testing, Limer and Hausman tests have been done and regarding the obtained results, we estimated the examined model. In this article we examined the following four variables as:

1.   The financial stability is calculated as the dependent variable from equation (1)

Equation (1):

$$Z_{it} = \frac{ROA_{it} + E_{it}/TA_{it}}{\sigma \, ROA_{it}}$$

Where $ROAit$ is return on assets

$EitTAit$: ratio of equity capital to assets

σ $ROAit$: deviation of return on assets

2. Competitiveness as an independent variable is calculated by equation (2):

Equation (2): $Lerner_{it} = (P_{TA_{it}} - MC_{TA_{it}})/ P_{TA_{it}}$

$P_{TA_{it}}$: income to properties ratio

$MC_{TA_{it}}$: costs to assets ratio

3. The ratio of doubtful receivables to assets (LLP) as the independent variable is calculated by equation (3):

equation (3): LLPit = ratio of doubtful receivables $_{it}$ / properties $_{it}$

4. The net interest margin (NIM) as an independent variable is calculated by equation (4):

Equation (4): NIM$_{it}$ = net interest $_{it}$ / earnings $_{it}$

The evaluated model will be as follows:

Equation (5): $Z\text{-}score = f(LERNER, LLP, NIM)$

$$Z\text{-}score_{it} = \alpha_0 + \alpha_1 LERNER_{it} + \alpha_2 LLP_{it} + \alpha_3 NIM_{it} + \varepsilon_{it}$$

In the evaluated model

Z-score: Financial Stability

LERNER: the competitiveness of the banking system

LLP: doubtful receivables to bank properties ratio

NIM: net interest margin

Stationary test of research variables

To avoid estimating spurious regression the variables stationary of financial stability equation should be assess and for this purpose stationary panel test should be used. The results indicated that the Lerner variable was non-stationary in three test, therefore Pedroni co-integration test is required to be done to confirm the absence of spurious regression in the model. In this method co-integration regression is estimated and then after that residuals stationary test of seven statistics will be used. Four cases of these tests combined auto-regressive coefficient among different banks during the unit root test. Therefore the first order autoregressive parameters will be limited to be the same for all banks. Pedroni introduced these statistics as panel co-integration statistics. Three other statistics are based on auto-regressive coefficients average that is estimated separately for each bank. Hence, these statistics allow the auto-regressive coefficients to vary from bank to bank which are known as panel average- group co-integration statistics. The first co-integration panel statistic is a non-parametric variance ratio test. The second and third type of panel statistics are rho, t, and Phillips Perron respectively. The fourth statistics is ADF panel which is similar to Levin et al., unit root panel test. Similarly, the first two group co-integration - mean panel statistics are rho, t, and Phillips Perron statistics

respectively. The third statistic is group- mean ADF which is similar to Imm et al., unit root panel test. The results of Pedroni co- integration test demonstrated that according to the majority of available statistics, there is co-integration between sample variables and lack of spurious regression in model is confirmed.

The Chow (Limer) test was used to recognize the sameness or difference in y intercepts. To this end F statistic will be obtained from estimated model according to the following hypothesis:

equation(6)

$$F = \frac{(R_{fe}^2 - R_{pool}^2)/(n-1)}{(1 - R_{fe}^2/(nt - n - k)}$$

Limer test hypotheses can be stated as follows:

$H_0 = \alpha_0 = \alpha_1 = \cdots = \alpha_n = \alpha$

$H_1 = \alpha_i \neq \alpha_J$

The null hypothesis states that a common y intercept can be used for all sections and the alternative hypothesis rejects α_i- for all intersections.

Chow test results confirm the presence of different y intercepts with the possibility of $p \leq 0.05$ and 95 % level of confidence. Therefore, the H_0 hypothesis is rejected and H_1 hypothesis is accepted.

Since the possibility of Hausman test statistic is $p \leq 0.05$, thus H_0 hypothesis based on using random method is rejected and model will be estimated using constant method.

Estimating Model

The obtained results of estimating the effect of banking system competitiveness model on financial stability in Iran using fixed effects method from 1391 to 1385 is demonstrated in the below table.

Table: Results of model estimation using fixed effects method

Banks		Variable name
Significance	coefficient	
0.0136	126.5700	Lerner
0.0055	369.5824-	LLP
0.0001	145.0736-	NIM
0.000227	4.447837	F statistics and possibility
0.49	R^2	
0.38	$\overline{R}^2$	
2.14	DW	

Source: research findings

According to the results of estimating model, all the independent variables with the possibility of $p \leq 0.05$ at 95 % level of confidence have significant relation with financial stability. Durbin-Watson numerical value is 2.14 which confirm the absence of auto-correlation in the estimated model. Moreover the coefficient of determining numerical value is 0.49

which approved the appropriate explanatory power of the model. It indicates that 49% of financial stability changes (dependent variable) is explained by the independent variables for the banks.

Hence, Lerner variable has significant and positive relationship with financial stability. In other words, with increased competition in banks, financial stability also increases. LLP variable has a significant negative relationship with financial stability. In other words, with increase in doubtful receivables, financial stability reduced and NIM relation with financial stability is significant and negative, in other words with an increase in interests, financial stability will reduced. In this regard it is necessary to note that there are private banks in our sample, and since the equity holders share interest, the obtained earnings from foreign banks' properties flow, thus legal reserve reduce, capital levels drop and stability will be shaken.

Conclusion

1. According to the results of the first hypothesis which stated that there is a significant positive correlation between competitiveness and financial stability, it is suggested that Policy makers and economic planners, money and credit council, and central bank prepare the field for banks by eliminating withholding policies so that banks would be able to freely compete with each other in providing diverse and innovative services and products to attract customers, therefore with increased competitiveness, financial stability also increase.

2. Based on the second hypothesis regarding that the significant negative relationship between doubtful receivables and financial stability, it is recommended that banks with strong determination attempt to collect their liabilities and employ officials who seriously try to collect receivables and avoid any connivance in this regard and at the same time paying any subprime loans. Moreover by offering the proposed package to debtors as forgiving some percentages of offenses reducing their non-current receivables and by minimizing receivables increase financial stability.

3. According to the third hypothesis that there is a significant negative relationship between interest and financial stability, it is suggested that banks provide situations in order to attract shareholders and make them entrust the banks so that they do not fully settle their dividend from the bank. At the same time sanctions, inflation, and economic dislocation also are involved in making such a situation, therefore it can be hoped that with the establishment of an agreement between Iran and the 5 + 1 countries the economic situation of the country improves.

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