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Iranian Banks

Struggling to Stay Balanced, as Challenges Intensify

Risk-adjusted capital ratios, corporate governance reports and references to "customer focused corporate culture" – at first sight, Iranian banks appear to be little different from banks anywhere else in the world.

Yet half of them are subject to some form of international sanctions and all of them are trying to make money in a country whose economy is under siege and whose currency can lose 10% of its value over the course of a single day.

So what's the state of the Iranian banking system?

Darien Middle East has been keen to bring to Iranian banks the kind of analysis that we have done on Gulf banks (see **www.darienmiddleeast.com** for the 2011 survey of 70 GCC banks). But getting to the bottom of Iranian banking is not easy.

First of all, disclosure is sometimes poor. Not all banks put their financial statements on their websites and some that do show results that are out of date. The Codal website (**www.codal.ir**) publishes regulatory filings to the Iranian Securities and Exchange Organization so is a good source of information, though it does not always keep data for years preceding the current one.

Despite these difficulties, it has been possible to put together a preliminary summary of Iranian banks' recent financial position (see Table 1).

On the face of it, most banks are showing strong funding in the form of retail deposits, a fairly low operating cost base, and reasonable profitability.

But when we look at asset quality, problems start appearing.

Non-Performing Loans Are Large and Are Increasing

Non-performing loans (NPLs) in the banking system as a whole totaled $50bn in 2010, according to publicly available information. In March 2011, capital funds of banking system – including government-owned development banks and specialized credit institutions – amounted to $28.8bn. It is unrealistic to think that the banks will suffer a total loss on their NPLs, but if the likely recovery rate is less than 40% (i.e. implying a loss of $30bn) then the banking system is technically insolvent, because if banks wrote down their loan portfolios today to their true value, their capital funds would be wiped out.

(And note that some Iranian banks start classifying NPLs when payments are six months past due, rather than the international standard of three months.)

As anyone who has spent time analyzing emerging market banks will tell you, the inescapable conclusion is that the Iranian banking system is bankrupt. In simple terms, the true value of its assets is less than the true value of its non-equity liabilities.

Some banks are better placed than others. Seven per cent of Semaan Bank's loans were classified as non-performing at the end of 1389, compared to 18% for Karafarin and 24% for Sadarat, but the underlying trend is disturbing. *continued on page 3* >>>

Exchange Rate Volatility Affects Banks, and Everyday Life

The exchange rate of the Iranian Riyal has become the subject of intense interest in Iran – and not just among bankers and businessmen. It's one of the main topics of conversation on the streets and in homes.

Two things have prompted this interest – the rapid decline of the Riyal's value over the last few months, and the government's clownish attempts to stop that decline.

Trouble has been brewing for some time. In a political move, the government ordered banks to cut interest rates in early 2011, with the result that depositors could earn only around 15% on a five-year facility. With inflation running at around 20%, that was unattractive and prompted a move out of Riyal deposits and into dollars and gold.

As international sanctions on Iran tightened and foreign exchange became more scarce, the demand for dollars and gold increased, prompting large withdrawals of Iranian Riyals from the banks. In some instances, banks had to limit or delay withdrawals by depositors, a move that in itself led to further withdrawals. By early January demand for dollars and gold had reached fever pitch. During the last week of January the exchange rate fell to 23,000 to the dollar – its lowest ever – and the price of a standard gold coin increased from six million Riyals to ten million.

This led to a confrontation between the Governor of the Central Bank of Iran, Mahmoud Bahmani, and President Ahmedinejad, with Bahmani threatening to resign if interest rates were not increased (so as to make local currency deposits more attractive, relative to dollars and gold). Ahmedinejad backed down and the Central Bank's Council of Money and Credit was authorized to manage deposit rates.

On 27 January, the Council told banks that they could charge what they liked for deposits. (And, just to be clear, that's >>>

TABLE 1: IRANIAN BANKS, SUMMARY OF FINANCIAL POSITION

Billions of Iranian Riyals, except where stated

			BALANCE SHEET				INCOME STATEMENT		
	Iranian Year	Assets ($bn)	Assets	Loans	Deposits	Shareholders' Equity	Operating income	General & Admin. Expenses	Net Profit
Bank Melli	1,389	80.3	823,363	525,550	553,161	43,992	6,460	2,162	3,901
	1,388	66.4	644,560	416,834	454,903	41,781	5,835	1,538	4,142
Bank Mellat	1,389	na	na	na	na	na	na	na	na
	1,388	48.6	474,251	261,778	324,990	18,640	10,113	4,463	1,731
Bank Tejarat	1,389	45.4	465,312	318,999	343,413	26,471	19,744	9,692	4,479
	1,388	39.5	383,487	271,456	268,676	22,096	17,074	7,215	3,354
Bank Sadarat	1,389	32.5	333,271	170,761	153,072	29,234	21,070	8,205	6,707
	1,388	28.4	276,077	145,411	144,732	24,237	14,759	5,623	3,688
Parsian Bank	1,389	27.5	281,501	208,020	302,814	20,225	9,821	1,981	5,510
	1,388	23.6	229,454	167,052	196,598	15,215	9,414	1,520	3,922
Bank Sepah	1,389	25.3	259,095	171,916	191,651	12,885	8,799	7,011	296
	1,389	22.9	222,559	148,767	158,792	12,555	8,920	6,346	141
Pasargard bank	1,389	17.5	179,228	109,594	139,549	31,499	9,288	1,573	6,064
	1,388	12.6	122,633	76,049	105,560	12,354	6,514	1,193	3,373
Eghtesadnovin Bank	1,389	13.3	136,311	97,915	111,944	9,849	6,491	1,508	2,978
	1,388	11.5	111,745	83,954	94,149	7,353	5,272	1,234	2,150
Ansar Bank	1,389	9.6	98,460	51,215	60,434	3,021	3,068	1,214	1,021
	1,388	na	na	na	na	na	na	na	na
Samaan Bank	1,389	8.3	84,912	60,256	55,189	4,831	3,045	895	1,355
	1,388	5.1	49,315	34,184	40,072	2,922	1,979	716	787
Sina Bank	1,388	4.7	47,828	34,937	41,847	4,507	2,859	775	1,181
	1,388	3.7	35,832	24,498	30,314	2,868	1,908	599	700
Karafarin Bank	1,389	4.2	42,613	27,106	31,454	5,964	2,844	573	1,813
	1,388	3.9	37,431	22,468	29,263	4,151	2,582	469	1,671
Bank Sarmayeh	1,389	4.0	41,142	24,706	29,812	4,780	2,688	605	890
	1,388	3.2	31,361	20,570	19,004	4,458	2,749	308	668
City Bank (Bank e Shahr)	1,389	2.3	23,770	6,549	19,492	3,070	1,664	435	983
	1,388	1.4	13,315	4,218	10,448	2,457	805	186	456
Postbank	1,388	1.6	16,230	10,708	12,677	802	1,640	195	204
	1,388	1.4	13,809	7,822	11,612	698	1,034	170	124
Tat Bank	1,389	1.4	14,652	6,441	3,459	3,232	2,378	305	1,236
	1,388	0.4	3,421	1,325	145	1,995	75	79	-4
Hikmat Iranian Bank	1,389	0.6	5,801	3,736	3,399	2,210	176	93	29
	1,388	na	na	na	na	na	na	na	na
Tourism Bank	3/1390	0.6	5,648	3,378	1,867	2,186	na	na	na

1. Unconsolidated results have been used, so as to present a purer picture of the bank's balance sheet and performance, although in the case of Bank Melli, only consolidated figures were available.
2. Recent figures were not available for Refah Bank and we were unable source comprehensive financial statements for Day Bank.
3. Iranian years end on 20 March, so figures for 1389 refer to 20 March 2011 and for 1,388 they refer to 20 March 2010.
4. Bank Mellat's figures refer to 22 August 2009.
5. The asset figures in dollars have been calculated using the exchange rate for 20 March 2011 ($1=IR10,250), for 20 March 2010 ($1=IR9,709.7), and, in the case of Bank Mellat's, 22 August 2009 ($1= IR9761.9). Exchange rates are taken from Oanda.com.
6. The figure for "Loans" includes loans to the private sector, the public sector and the government.
7. The figure for "Deposits" includes sight deposits, savings deposits, term investment deposits and "other" deposits.

TABLE 2: CONSOLIDATED BALANCE SHEET OF COMMERCIAL BANKS

Trillions of Iranian Riyals Billions of US $*	MARCH 2011*	MARCH 2011	MARCH 2010	MARCH 2009
Foreign assets	66.9	686	465	353
Claims on public sector	27.5	281	206	143
Claims on private sector	202.9	2,080	1,624	1,467
Assets = Liabilities	414.8	4,251	3,303	2,784
Deposits of public sector	8.9	91	87	69
Deposits of private sector	232.4	2,382	1,887	1,532
Equity	19.3	198	147	148

Figures refer to the 20 state-owned and privately-owned commercial banks. They do not include state-owned specialized banks (such as Bank of Industry and Mine) or other specialized banks. The figures in US Dollars have been calculated using end of year exchange rates published by Oanda.com. The source for the data is the Central Bank of Iran.

On the assets side of the balance sheet, commercial banks show a large item termed "other" assets, and on the liabilities side they show large items termed "other" liabilities and "foreign exchange loans and deposits."

The dates refer to the Iranian years 1389, 1388 and 1387, which end on 20 March 2011, 20 March 2010 and 20 March 2009.

In 2004, NPLs accounted for 10% of all loans in the system, official figures say. That's high but not completely out of line with what is seen in some other emerging markets. In contrast, the 2010 figure of $50bn represents 25% of all loans, and not only raises the questions on solvency that we've already mentioned, but also the quality of credit appraisal within the banks, and the quality of banking supervision in the Central Bank. (Though, to be fair, the effect of international economic sanctions and, in particular, the loss of access to foreign exchange, is causing difficulties to many companies that under normal circumstances could be expected to perform reasonably well.)

Of course, as with any banking system, the financial statements don't tell the whole story, and that is certainly true in Iran.

Some banks have experienced "runs" and have restricted withdrawals

Three Iranian banks – including Bank Sadarat – are reported to have suffered "runs" in the last few weeks as depositors rushed to withdraw their money. The runs were caused by dramatic falls in the value of the Iranian Riyal. Depositors responded to the devaluations by withdrawing funds from their riyal-denominated accounts with the intention of converting the riyals into hard currency or gold coins. Withdrawals reached such a pitch that the banks had to limit daily withdrawals.

Significantly, the withdrawal limits seem to have been imposed not in order to stem the conversion of money into hard currency or gold – it was simply a case of the banks not having enough local currency liquidity to meet customers' demands. That's worrying for two reasons.

First, it's extremely rare for banks not to be able to pay their local currency obligations – it generally only happens when a bank is in deep trouble. Second, no one expects that the Riyal exchange rate will stabilize any time soon, so if exchange rate problems are the reason why banks prevent depositors getting at their money, then bank runs are going to keep happening.

Corruption Scandals Point to Political Interference

Confidence in the banking system has also been damaged by the corruption scandals that began emerging in September 2011 with revelations that an obscure businessman – albeit one with close ties to the regime – had been able to fraudulently acquire $2.8bn in funding from leading banks. (Simply put, the allegations are that the suspect, Amir-Mansour Kosravi, was able to get Bank Sadarat to give him letters of credit and then he used those letters to get more money from about seven other banks, including the largest private sector bank, Bank Melli.)

The worrying aspects of the scandals lies less in the sums of money involved than in what happened next.

Within weeks, the Managing Director of Bank Melli had fled to Canada, the head of Bank Sadarat had been removed, the Managing Director of Bank Tejarat was placed under investigation, the head of Bank Maskan was arrested, and the head of Bank Tat was dismissed. Nor was the Central Bank left unscathed – Deputy Governor Pourmohammedi was arrested in October.

a huge policy shift– interest rates had been set centrally for decades.) The following day the government outlawed unofficial exchange transactions. On 3 February Supreme Leader Khamene'i referred to the exchange rate issue during Friday prayers – condemning currency speculation.

Yet the exchange rate remains fragile. On 8 February, 180 members of the Majlis expressed their intent to pre-empt the European oil embargo on Iran by immediately halting oil sales to Europe. In response, the exchange rate dropped from 17,600 to 20,000, before settling back to about 19,000 the next day.

The exchange rate drama has had moments of farce. At one point the government blocked text messages containing the word "dollar." It also interfered with some websites such as mesghal.com that provide instant quotes on foreign exchange and precious metals.

More seriously, evening news shows have been broadcasting stories about people who have been apprehended in the street with foreign currency but no receipt of origin, and who therefore had the foreign currency confiscated. Prices of many electrical items are now quoted in foreign currency. The supply of cars from Dubai is drying up. For those dealing in foreign goods the issue is not so much the depreciated value of the Riyal but the uncertainty around it – they just don't know what price to buy or sell at without running the risk of a loss.

The effects of this on the banking system are many. Most obviously, already high non-performing loan ratios look set to increase as customers dependent on imports face difficulties or go out of business. Even good companies are going to have problems as banks increase interest rates on loans to compensate for the increased deposit rates. If banks end up paying out 20% on deposits (and that is the rate that some are now advertising) they will have to charge nearly 30% on loans. As one banker wisely said, "Anyone willing to pay 30% on a loan is not someone you should be lending to!"

The recent events have served to keep foreign exchange out of regulated banks and money changers – the opposite of what the government wants. Expectations that the exchange rate will fall further will likely lead to further withdrawals from local currency deposits as customers seize on the limited opportunities to buy foreign exchange. ■

It was very clear at the time that these arrests and investigations had more to do with politics than with banking and, from a banker's perspective, that's worrying. Darien Middle East has analysed banks in Western Europe, Eastern Europe the Middle East and in the Former Soviet Union and one thing we've learned is that when you see politicians interfering in banks, then the banks are going to be in trouble.

It's not easy to get to the bottom of what's been going on – and we've really tried – but there seem to be two broad themes at play. The first is that control systems are weak and/or unenforced. Kosravi is alleged to have acquired fraudulent letters of credit from several banks, over several years. Fraud is often difficult to detect, but one thing that's not difficult to see is someone who was a modest businessman a few years ago suddenly engaging in transactions worth billions of dollars. That's a red flag anywhere in the world, and the heads of the Iranian banks and the Central Bank either didn't see it or couldn't do anything about it.

Which brings us to the second theme – political connections.

One set of allegations says that political figures were easing Kosravi's path in exchange for political donations to President Ahmedinejad's friends and associates. Such allegations draw strength from a widely-circulated letter, allegedly from Presidential confidant Esfandiar Masha'ei, to two government ministers telling them to facilitate the purchase by Kosravi of state assets being privatized and not to worry about the "formalities" ("tasharruffaat" in Farsi). Masha'ei and Ahmedinejad have been political allies for years, and Masha'ei's daughter is married to Ahmedinejad's son.

Ahmedinejad's associates counter that circles around Supreme Leader Khameni'e are trying to discredit them as part of a campaign to ensure that Ahmedinejad stays out of politics when his second (and therefore, final) presidential term finishes in June 2013.

The involvement of political figures and organizations in the Iranian economy is nothing new. For example, relations between Ahmedinejad and the Iranian Revolutionary Guards Corp are close and have been well reported. When Ahmedinejad began privatizing state companies, the Guards were able to snap up some of the best assets. As for the banking sector, what is well known is that Guard-controlled companies have stakes in Ansar Bank and the Mehr finance company.

Why does this matter? Because Iranian politics is fractious at the best of times and Parliamentary elections in March this year, increasing economic pressure and Presidential elections next year will make it even more so.

So, we have an insolvent banking system that's already suffering runs on deposits and which can, and will, be increasingly used by regime figures to finance political campaigns and buy influence.

Is the picture entirely gloomy?

No, the picture is not entirely gloomy.

Iranian banks have enjoyed fat margins: until recently they've been paying 6 – 15% on deposits and charging about 25% on loans. They are operating in a sizeable economy -- Iran's Gross Domestic Product is about $340bn (at current prices). That's nearly as big as Saudi Arabia, the biggest Arab economy, and far bigger than Egypt. It's in the same league as Thailand and South Africa. And of course there is a population of about 75 million. Investment banking services are generating new revenues and electronic banking is increasing retail banking efficiency.

There is business to be done with local companies, provided that they are not dependent on imports and foreign exchange. For the moment, Chinese and East Asian companies are happy to pick up the business that more scrupulous institutions decline (although the recent sanctioning of China's Zhuhai Zhenrong and Singapore's Kuo Oil (both oil traders) demonstrate not only the long-reach of the U.S. but also its willingness to annoy important trading partners in its search of sanction-busting companies).

Left alone, Iranian banks would be making plenty of money, generating internal capital, and doing all the other things that normal banks do (including, presumably, upgrading fraud prevention measures). But they are not left alone. Most of the largest banks are subject to some form of economic sanctions and all are going to be increasingly subject to political pressures. The exchange rate problems are going to wreak havoc.

Darien Middle East will continue to monitor Iranian banks and we plan to publish further analyses in the months ahead. ■

U.A.E. branches, once flourishing, now wilting

It's hard to miss the Bank Melli branch on Dubai's Creek. It may no longer be one of the biggest buildings on the waterfront, but it's big enough to make you wonder what's happening inside, given that the bank has been under U.S. sanctions since 2007, E.U. sanctions since 2008 and – along with all other Iranian activity in the U.A.E. – subject to increasing pressure from the local regulators.

Iranian banks were among the first to establish branches in the U.A.E. Melli began operations in Dubai in January 1970. Bank Sadarat had preceded it two years earlier. Many of the older generation of Emirati businessmen still have accounts with Iranian banks.

Statistics published by the Emirates Banking Association show that Bank Melli's branches held assets of $3.3bn at the end of 2010, representing about 5% of its total assets. Sadarat's branches held assets of $5.7bn, representing about 20% of the bank's total.

We don't have more recent statistics on those banks' U.A.E. operations, but people we speak to in Dubai say that Melli has had to curtail pretty much its entire business as a result of the combined effect of legal restrictions arising from sanctions, and financial pressures which follow. Sadarat, and Persia International Bank (a joint venture of Melli and Bank Tejarat) are facing similar difficulties. ■

Andrew Cunningham has spent more than 25 years writing, training and consulting on banking and finance, both in the Middle East and in Europe and the U.S.

Darien Middle East advises clients on international financial regulation and best practices in risk management and corporate governance. The firm was founded in 2010 by Andrew Cunningham and is based in London. The firm publishes regular briefings on financial markets under the title, Darien Analytics.

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