The Impact of the Political Instability on Bank's Performance: Evidence from Iraq

Hamid Mohsin Jadah,
Department of Finance and Banking, College of Administration and Economics, University of Kerbala, Iraq.
hamidmohsin40@gmail.com
hamed.m@uokerbala.edu.iq
ORCID: https://orcid.org/0000-0002-8170-5453

Noor Hashim Mohammed
Department of Finance and Banking, Imam AL-Kadhum College for Islamic Studies- Babylon Departments
noorhashim136@gmail.com
ORCID: https://orcid.org/0000-0001-9206-6530

Md. Mahadi Hasan
Department of Business Studies, Anwer Khan Modern University, Dhaka, Bangladesh
mahadihasan82@gmail.com

Adetayo Olaniyi Adeniran
Department of Transport Management Technology, Federal University of Technology, Akure, Nigeria
adeniranao@futa.edu.ng

Abstract:

This study aims to empirically investigate the impact of political instability on bank's performance. A sample of selected listed banks at the Iraq Stock Exchange (ISX) was used to test the aforementioned relationship. This study utilized secondary data collected from an annual financial report for selected banks. Moreover, Political instability indicators were collected through World Development Indicators databases. The impact of political stability and bank's performance is tested for the pre- Islamic State of Iraq and Syria ISIS period (2009-2013) and during ISIS period (2014-2017). The study used panel GLS to attain the proposed objectives. Diagnostic tests such as heteroskedasticity, normality, serial correlation and multicollinearity were performed before employing GLS. The results revealed that there is a significant negative association between political instability and bank performance during-ISIS period. This research contributes knowledge in the field of political instability and bank performance in Iraq.That said, this paper provides significant contributions to the theoretical

literature, the industy, and policymakers so that the Iraqi conventional banks' performance can be enhanced in the environment with chronic political instability.

Keywords: Bank Performance, Iraq, ISIS, Panel data method, Political Instability.

Jel Clasification: C33; G21; N45; P16.

1. Introduction

It is an established fact that the financial sector, particularly the banking, is of the leading components in the growth of the global economy (Mohyuldin et al., 2017). In fact, a stable banking system is the main ingredient for a successful and wealthy economy (Levine, 1997). In Iraq, conventional banks started about five decades ago and they played a major role in financing and contributing to various economic and social sectors in the country. As a result of their economic contribution, many researches have been conducted on banking sector but while there have been major events such as the ISIS which surely impacted the financial and economic activities in the region, particularly Iraqi economy.

Because of ISIS, uncertainty and instability are the major challenges for Arab economies. Since, economy health is strictly linked to reliability, transparency, and people's trust in the financial sector. While banks are the major players in economies, the objective of this study is to investigate the impact of the political crisis's on the Iraqi banking sector performance for pre and during ISIS period.
Since 2003, the political process in Iraq has been experiencing series of crises arising (political and sectarian conflicts, unresolved quota system etc) which resulted in internal economic crises and contributed to the entry of ISIS terrorist gangs to parts of Iraq (Alnasiri, 2015).

Acording to the previoud literature, very few studies examined the impact of political instability on bank profitability particularly during the ISIS period. Therefore, it needs to further investigation particularly in the context of the Iraqi financial sector due to it has a unique condition because of the War and the occupation of ISIS terrorist groups. According to the authors best knowledge, the association between political instability and banking performance is unexplored in Iraq, particularly a comparative study pre-ISIS and during ISIS period. Furthermore,this sdudy aims to investigate the impact of the political instability on banks' performance in Iraq and to brovid recommendations and suggestions for managers and policy makers of Iraqi banks to improve financial performance of commercial banks of Iraq. This paper fills the gap in the literature by examin the impact of politalcal instability on bank performance and compare this impact between two period. First, pre the occupation of ISIS terrorist groups and during ISIS period.

The remain of the current research is organized as follows. The the political instability on banking sector performance and the related theories were reviewed in the second section. The following section discusses the research methods. Section 4 and 5 presents empirical findings, discussion, and the conclusion respectively.

2. Literature Review

Past studies investigated the impact of political instability on economic performance, economic growth, financial development, bank stability, and human development indicators. For instance, the study of Campos, Karanasos and Tan (2011) reported that a positive relationship between political instability and economic activities which may indirectly affecting the financial development. Similarly, Aisen and Veiga (2013) also tested the association between political instability and the growth ot the economic for 169 economies for the period of 1960 to 2004 using a system-GMM estimator. This study reported that political instability may negatively affect growth by decreasing the proportions of productivity growth. Moreover, Using the period of 1972-2009 in Pakistan, Ali et al. (2013) reported that there was a adverse association between political instability and domestic private investment. Furthermore, Huang (2010), using a sample of 90 countries during 1960 to 1999, the study pointed out that financial development is positively associated with institutional quality in the short run in the case of low income, ethnically divided, and French legal origin region. The study also stated that political instability may result in a high level of volatility in financial development while institutional reforms were positively linked with finance suppliers. It indicates that institutional quality and economic performance are positively related.

Using a generalized method of moments (GMM) for the period of 1990-2005 and the sample area of 50 African countries, Batuo and Kupukile (2009) showed that financial and economic liberalization significantly contributes to financial development. Besides this, the study also reported that political stability positively affected the financial development. Another study such as Zhang (2007) concluded that political institution can interfere with financial development in the small developing countries like Malaysia and Thailand. In the same way, the study of Outreville (1999) found that both human capital and political stability were positively associated with financial development in 57 developing countries using panel regression.

Using Ordinary least square (OLS) for Middle-East and North-African regions' firms, the study by Herrala and Ariss was showed that an inverce association between political instability and financial development. Nevertheless, Bloom (2007) stated that uncertainty event such as oil- price shock and the 9/11 on financial development may have an adverse impact on investment and productivity in USA. The results reported that uncertainty may retards the investment and productivity may also fall using vector-auto-regression (VAR). As a result, firms (finance-deficit units) may not require finance and it may affect the financial development. The study of Jackowicz et al. (2013) examined the relationship between political factors and banks' performance of 11 European banks during 1995 to 2008. The study exposed that Government-owned commercial banks form a way to fulfil political objectives in the area of the central European region.

Brini and Jemmali (2016) examined the relation between political instability for Tunisian bank stability. GARCH and E-GARCH models were applied on the data for the period 2009-2012. The findings showed that the Tunisian banking system were more stable during the political stability period. Furthermore, Political instability on economic growth was examined by Azez (2013) in Iraq. The study indicated that political instability had a significant impact in declining economic growth as well as increase the inflation percentage.

In a nutshell, the majority of the past studies investigated the impact of political instability on economic growth, bank stability, foreign direct investment, security market, and economic performance. However, few studies examined the association between political instability and bank profitability particularly pre and during ISIS period. The result of the previous studies is inclusive and contradictory. Therefore, it needs further investigation. Moreover, the result is varied due to contextual issues. The context of the Iraqi financial sector is a unique condition because of the War the occupation of ISIS terrorist groups. According to the best knowledge of authors, the association between political instability and banking performance is unexplored in Iraq, particularly a comparative study pre-ISIS and during ISIS period.

3. Research Methodology

3.1 Sample and Data Collection

This study used content analysis from the annual report and panel data method in analyzing the influence of political instability on banking performance for the listed banks at the ISX for a pre-ISIS period (2009 to 2013) and during ISIS period (2014 to 2017). The study sample consists of twenty-three (23) banks listed on the ISX for the specified period which limited to eighteen (18) banks due to unavailability of data for few banks. Some of the data were collected from the annual financial reports of the selected Iraqi banks, World Development Indicators (WDI) and World Governance Indicators (WGI). This study used descriptive statistics, Pearson correlation and panel data multiple analysis.

Table 1: Measurement of Variables

Variable(s)	*Symbols*	*Operationalisation*
Return on assets (bank profitability)	*ROA*	*ROA = return/total assets*
Political instability	*PIS*	"The likelihood of political instability and/or politically-motivated violence, including terrorism" [(1)]
	Control Variables	
Bank Size	*BSIZE*	*Taking a natural logarithm of the Total Assets*
Inflation	*INF*	*Inflation*
GDP growth	*GDPG*	*GDP Growth*

Source: Compiled by the Author (2019)

3.3. Data Analysis Method

The quantitative data method is utilized in the current study. panel data multiple analysis are done using E-views software version 10.

3.2 Model specification

This study examines the impact of politicla instability on the performance for Iraqi banks using a panel data approach. The reason for using the panel data approach is to obtain more precise findings by making more observations. Using the panel data approach to study the

[1] The score of total indicators for countries ranged between approximately -2.5 to 2.5.

critical determinants of bank performance is what is newly introduced in this study (Baltagi, 1995). The model specification is expressed in specification can be written as follows:

$$ROA = f(PINS, BSIZE, GDPG, INf) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (1)$$

$$ROA_{it} = \beta_0 + \beta_1 PINS_{it} + \beta_2 BSIZE_{it} + \beta_3 GDPG_{it} + \beta_4 INF_{it} + \varepsilon_{it} \ldots\ldots\ldots\ldots \quad (2)$$

Where:

ROA = Return on Assets

PIS= Political Instability

BSIZE = Bank Size (Log of Total Assets)

GDPG = GDP Growth

INF = Inflation

β_0 = *Intercept or constant.*

$_i$ = *1, 2, 3….. 18 indicating the number of banks that will be used for the study*

$_t$ = *1, 2, 3 ….9 indicating the time period that will be used for this study (2009-2013 and 2014-2017)*

$\beta_{1\text{-}4}$ = *Coefficient of independent variables.*

ε_{it} = *The error term.*

3.3 Research hypothesis

To achieve the study objectives, the following hypotheses are stated:

H1: Political instability has insignificant effect on bank performance in Iraq for the period pre ISIS (2009-2013).

H2: Political instability has a significant negative effect on bank performance in Iraq during the period of ISIS (2014-2017).

4. RESULTS AND DISCUSSION

4.1 Descriptive statistics

Table 2 summaries the descriptive statistics for the pre ISIS period (2009-2013).

Table 2: Descriptive Statistics of Pre-ISIS Period (2009-2013)

	Mean	Median	Maximum	Minimum	Std. Dev.
ROA	0.06	0.077	0.087	-0.123	0.039
PIS	-2.006	-1.97	-1.843	-2.256	0.145
BSIZE	8.232	8.257	9.199	6.981	0.481
GDPG	7.653	7.5	13.9	-2.1	4.201
INF	4.153	4.34	6.089	1.879	1.841

Table 2 above illustrates the descriptive statistics for the dependent variable and the independent variables used in the study for the Pre-ISIS Period (2009-2013). The dependent variable is the return on asset (ROA), while the independent variable is political instability (PINS) whilst bank size, GDPG and inflation were taken as control variables. Table 3 illustrates the descriptive statistics of during-ISIS period (2014-2017).

Table 3: Descriptive Statistics of During-ISIS Period (2014-2017)

	Mean	Median	Maximum	Minimum	Std. Dev.
ROA	0.064	0.080	0.087	-0.12	0.032
PIS	-2.350	-2.322	-2.260	-2.48	0.082
BSIZE	8.396	8.473	9.214	6.834	0.512
GDPG	7.565	7.500	13.900	-2.100	5.361
INF	2.961	2.236	6.089	1.393	1.901

4.2 Correlation Results

Correlation analysis is carried out to detect any autocorrelation between political instability and bank profitability variables. Table 4 depicts the correlation matrix for the pre-ISIS period (2009-2013).

Table 4: Pearson Correlation of Pre-ISIS Period (2009-2013)

Probability	ROA	POLINS	BANKZ	GDPG	INFLATION
ROA	1				
PIS	-0.122**	1			
BSIZE	0.2781**	-0.181**	1		
GDPG	0.329**	-0.438*	0.349	1	
INF	0.114	0.430	-0.033	-0.288	1

Note: ****, *** indicate significant at 0.01 level, 0.05 level, respectively.

Table 5 illustrates the Pearson correlation coefficients to measure the strength of relationships amongst the variables in this study for during ISIS period (2014-2017).

Table 5: Pearson Correlation of during -ISIS Period (2014-2017)

Probability	*ROA*	*POLINS*	*BANKSZ*	*GDPG*	*INFLATION*
ROA	*1*				
PIS	*-0.0322***	*1*			
BSIZE	*0.3254***	*0.2656***	*1*		
GDPG	*0.1943***	*0.1886**	*0.1064*	*1*	
INF	*-0.0311*	*0.1087*	*-0.0053*	*0.0583*	*1*

Note: ****, *** indicate significant at 0.01 level, 0.05 level, respectively.

Furthermore, the table shows that the correlation coefficient amongst return on assets and political instability for both of the periods (pre and during-ISIS) is negative and significant, indicating a negative association between them. Table 4 and Table 5 showed that none of the correlation coefficients between the variables is higher than 0.80. According to Gujarati (2003), if the correlation coefficients are higher than 0.80, it might lead to a multicollinearity problem between the variables.

4.3 Regression Analysis

Before regression analysis, several diagnostic tests i.e. multicollinearity test, normality test, serial correlation test, and Heteroskedasticity test were applied which showed that our data have serial correlation problem. According to Petersen (2009), when the data suffering from any of the problems mentioned above, the suitable method is generalised least squares (GLS). Hence, GLS was applied and the results of the panel GLS regression of political instability on the performance of banks using ROA as a measurement.

4.3.1 The pre ISIS period (2009-2013)

The results of the panel data regression of political instability on the performance of banks using ROA as a measurement for pre-ISIS period (2009-2013) are depicted in Table 6 as below:

Table 6 Regression Analysis of Pre-ISIS Period (2009-2013)

Variable	Coefficient	t-Statistic	Prob.
PIS	-0.1405	-1.1585	0.2508
BSIZE	0.0258**	3.8098	0.0003
GDPG	0.0008	1.0906	0.2793
INF	-0.0023	-0.4545	0.6509
Constant	-0.4822*	-1.7691	0.0184
R-squared	0.4550		
Adjusted R-squared	0.2200		
F-statistic	5.2538		
Prob(F-statistic)	0.0009		
Durbin-Watson stat	2.3363		
N	117		

Note: **, * indicate significant at 0.01 level, 0.05 level, respectively

Table 6 illustrates the result of the panel for the pre-ISIS period (2009-2013). The probability of the f-statistics is less than 1% which reflect one the model fitness criteria. Moreover, the result of Durbin-Watson statistics is 2.3364 which is very near to benchmark value (i.e., 2). It can be said that there is on multicollinearity issues in this model. Further, the adjusted R2 is 0.22 for the model which means the explanatory variables is explained by 22%.

The result shows that only the bank size (BSIZE) is positively associated with banking performance at 1% level of the p-value. It means the bigger size of the bank increase the performance of the bank. However, PIS, GDPG, INF are found insignificance with bank performance. It means that these factors might not contribute to the banking performance in the pre-ISIS period. This finding is consistent with first hypothesis of this study.

4.3.2 During-ISIS Period (2014-2017).

The results of the panel data regression of political instability on the performance of banks using ROA as a measurement for the during ISIS period (2014-2017) are depicted in Table 7 as below:

Table 7 Regression Analysis of during-ISIS Period (2014-2017)

Variables	Coefficient	t-Statistic	Prob.
PIS	-0.5947**	-7.7860	0.0000
BSIZE	0.0281*	a2.4074	0.0198
GDPG	0.0015**	2.6136	0.0098
INF	-0.0023	-0.4545	0.6509
Constant	-0.1633**	-3.6314	0.0004
R-squared	0.5294		
Adjusted R-squared	0.4213		
F-statistic	4.8952		
Prob. (F-statistic)	0.0000		
Durbin-Watson stat	2.3363		
N	177		

Note: ** indicate significant at 0.01 level,* indicate significant at 0.05 level.

In Table 7, it presents the result of a panel fixed effect approach of the during-ISIS period (2009-2013). The probability of the f-statistics is less than 1% which reflect one the model fitness criteria. Moreover, the result of Durbin-Watson statistics is 2.3363 which is very near to benchmark value (i.e., 2). It can be said that there is on multicollinearity issues in this model. Further, the adjusted R2 is 0.4213 for the model which means the explanatory variables is explained by 42.13%.

The coefficient of PIS is negatively significant with banking performance in the during-ISIS period at the level of 5%. It means that there is a adverse association between political instability and returns on assets of Iraqi banks after ISIS period. This finding consistent with the second hypothesis of this study. Moreover, previous studies such as Jadah *et al*. (2020), Şanlsoy et al. (2017), Ghosh (2016), and Jebnoun (2015) are supported this finding. The plausible reson behind the negative impact of political instability on Iraqi bank performance during ISIS period due to the control of ISIS over a number of banks in the city of Mosul has a negative affect on the performance of banks in general, and on the performance of private banks in particular. Moreover, this situation has negative impact on the citizen confidence, whether Iraqi or foreign, in the capability of stat in protecting the banking system. Furthermore, the feelings of fear dominated most of the citizens because they felt that the protection available to banks and all international facilities is fragile. Additionally, these feelings made the foreign investor and the ordinary citizen apprehensive of depositing in banks and lose confidence in banking systems, which reflected negatively on the performance of Iraqi banks.

As for the control variables, the bank size and GDP growth are positively significant with ROA at the level of 10% and 5%, respectively. However, Inflation is negatively related to ROA but it has an insignificant relationship between them.

5. Concluding remarks

This study investigates the influence of political instability on banking performance for pre and during ISIS period. Iraq suffering from chronic political instability. This situation affects the Iraqi as a whole and the banking sector in particular. An empirical estimation based on panel GLS models is performed to determine the influence of political instability on banking performance. The results showed that the banking system is more stable pre ISIS occupation compare with the period of ISIS occupation. The negative impact of such a major event is observable and clear and has important policy implications. The main reason for such negative impact is principally the anxiety and no confidence of investors due to the political instability. Then, the monetary policy makers and managers need to mitigate its negative effects and inhance the confidence in the banking system thrugh create deposit trust agencies.

The present study recommended that the policymakers of Iraq should focus on political instability to boost up banking performance. As a result, the investors feel safe environment to attract investors for better performance of economic and banking. Moreover, they need to control inflation to reduce budget deficits. This research was limited to commercial banks in Iraq. Moreover, further research could be compared between two near economically developed counties.

References:

Aisen, A. & Veiga, F. J., 2013, How does Political Instability Affect Economic Growth?, *European Journal of Political Economy* 29, 151-167.

Ali, S. H., Hashmi, S. H., & Hassan, A., 2013, Relationship between Political Instability and Domestic Private Investment in Pakistan: A Time Series Analysis. *Pakistan Business Review 15*, 1-26.

Alnasiri, S. A., 2015, Iraqi Economy Crisis : Challenges and Opportunities for Reform. *Network Iraqis Economists*. Retrieved from http://iraqieconomists.net/ar/2015/11/09

Al-Sarhan, H., A., 2015, The Impact of Political Non-stability on the Indications of Human Development in Iraq following 2003, *Ahl Al-Bayt Peace be upon them Journal* 18, 16-44.

Azez, F. K., 2013, The Impact of political Iinstability on Economic Growth in Iraq, *Alustath Journal* 2, 85-96.

Baltagi, B. H. (1995). Econometric analysis of panel data. New York: John Wiley and Sons.

Batuo, M. E., & Kupukile, M., 2009, How Can Economic and Political Liberalisation Improve Financial Development in African Countries? *Munich Personal RePEc Archive.*

Bloom, N., 2007, The Impact of Uncertainty Shocks. *NBER working paper series paper 13385.*

Brini, R., & Jemmali, H., 2016, The Impact of the Political Instability on Conventional Banks' Stability: Evidence in Tunisia, *IIARD International Journal of Banking and Finance Research* 2, 105-113.

Campos, N. F., Karanasos, M. G., & Tan, B., 2012, Two to Tangle: Financial Development, Political Instability and Economic Growth in Argentina. *Journal of Banking & Finance 36*, 290-304.

Ghosh, S. (2016). Political Transition and Bank Performance: How Important was the Arab Spring?. *Journal of Comparative Economics, Elsevier 44*, 372-382.

Herrala, R., & Ariss, R. T., 2013, Credit Constraints, Political Instability, and Capital Accumulation. *IMF working Paper 13/246.*

Huang, 2010, Political Institutions and Financial Development: An Empirical Study. *World Development 38*, 1667-1677.

Jadah, H. M., Alghanimi, M. H., Al-Dahaan, N. S., & Al-Husainy, N. H. (2020). Internal and External Determinants of Iraqi Bank Profitability, *Banks and Bank Systems, 15(*2), 79-93.

Jackowicz, K., Kowalewski, O., & Kozłowski. L., 2013, The Influence of Political Factors on Commercial Banks in Central European cCountries, *Journal of Financial Stability*, 9, 759–777.

Jebnoun, S. A., 2015, Tunisian Banking System Vulnerabilities Beyond the Global Financial Crisis and Recent Political Instability, *Case Studies Journal 4*, 112-117.

Outreville, J. F., 1999, Financial Development, Human Capital and Political Stability. *UNCTAD Discussion Papers 1-22-*.

Petersen, M. A., 2009, Estimating Standard Errors in Finance Panel Data Sets: Comparing Approaches. *The Review of Financial Studies* 22, 435-480.

Sanlsoy, S., Aydn, Ü. & Yalçnkaya, A., 2017 Effect of Political Risk on Bank Profitability. *International Journal of Business Management and Economic Research 8*, 998-1007.

Zhang, X., 2007, Political Parties and Financial Development: Evidence from Malaysia and Thailand. *Journal of Public Policy 27*, 341-374.