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## Factors of Failure of the Iraqi Banking System in the Implementation of the Decisions of the Basel Committee

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### Abstract

The role of the banking system is very important and sensitive in any inquisitive system in our modern world, because it is the other side of this economy in exchange for real activities and the great crossroads of the efficiency of the economic system and the legitimacy of its organizations according to the basic objectives of each national economy in any society. Based on this importance above, the importance of applying the banking system to the rules and decisions of the Basel Committee in all its copies<sup>1</sup> (1), which can ensure that the banking system could avoid the risks that can lead to the entry into crises and serious intransigence. This paper seeks to provide a broad presentation of the possibilities of application of the Iraqi banking system to the decisions of the Basel Committee and seeks to provide a presentation of obstacles and factors that led to the failure of the Iraqi banking system to implement the decisions of the Basel Committee in all copies and both internal and external. This paper also seeks to look at the possibility of adapting the banking system in order to comply with the requirements of the implementation of Basel decisions from an economic and financial point of view represented by the views of economists and financial institutions inside and outside this body.

**Keywords:** banking system, basel committee decisions, and internal and external failure factors

### Introduction

The efficiency of the performance of the banking system is of great economic importance. This path can be achieved through the application of the banking system's standards to respectable efficiency standards and this has become urgent in the Iraqi banking system for the Iraqi economy to reach the edge of the beginning of development, especially after 2003, which marked the country's embrace of the market economy and openness to the world.

This paper examines the factors and reasons behind the failure of the Iraqi banking system to implement of Basel III standards issued by the Basel Committee on International Banking Supervision.

This paper has reached the factors and categorized them internally and externally from inside and outside the banking system and reached a number of reasons that are concentrated in institutional weakness and its unfavorable pattern for the implementation of international standards such as Basel III, And the weakness of the methods of assessment of risks and inaccuracies in the selection of guarantees for credit as well as administrative and logistical problems play an important role in this as one of the reasons for the internal failure of the Iraqi banking system in the application of standards Basel III. This is related to many objective reasons emanating from the general environment in Iraq in all economic, legal and political aspects, such as the poor legislation and the economic system, the low ability of the authorities to implement the law, the effects of the influence of politicians as well as the important issue which is the lack of integration of the financial market which is not integrated and does not

<sup>1</sup> Bank of international settlements, Basel committee on banking supervision, finalizing Basel III In brief, Basel, 2017

play its role in accordance with the role of the typical system as well as the absence of an automated payment system that provides financial information and data to the regulatory bodies, especially the Central Bank to be able to apply international standards for banking.

This paper focused on the possibility of delaying the implementation of Basel III now and only uses the implementation of the Basel I and II standards until the completion of the shortcomings of the internal and external banking system then it may be qualified in this context to apply standards Basel III later.

### **Component of the Iraqi Banking System**

The banking system consists of several types of institutions that manage the life of cash and financing now and we will try to display these items to give a clear image of the scope of our study.

#### **First: The central Bank of Iraq:**

It is obvious that each country has a central bank that manages the life and monetary policy of the country. As it is clear, Iraq has this body that manages the cash operations as well as monitoring and managing the cash flow exported to the Iraqi economy. This institution was characterized by its heritage and old. This bank was established with the beginning of the establishment of the modern Iraqi state under the name of (Iraqi National Bank) in 1947 on the ruins of (The Currency Council) that established by the British Mandate authority of Iraq in London in 1931. The Council was formally abolished in 1949. In 1956, the National Bank of Iraq became the Central Bank of Iraq. Its responsibility included issuing currency, controlling foreign exchange transactions, supervising and supervising the banking system<sup>1</sup>. The Central Bank exercises these roles in varying and fluctuating proportions of success for reasons related to its style of performance and level of independence as an independent body, as well as the general situation that the state has been going through since 2003 and so far. With regard to its role in the implementation of Basel Committee decisions and standards, the Central Bank established the Financial Stability Section in 2017.

This section is concerned with the implementation of Basel decisions and standards and measuring the quantitative impact before application with regard to adequacy and ratio analysis LCR and NSFR<sup>2</sup>, and measuring the compliance of Iraqi banks with international standards, especially Standard No. (9)<sup>3</sup>.

#### **Second: Governmental and Private Commercial Banks:**

Commercial banks are the main financing mechanism and the most important part of the structures of the banking system that practice banking and finance in any economy. The most important criteria for the efficiency of the financial and financial apparatus of any country are the efficient performance of these banks in all their classes and methods of managing them and dealing with their duties. The Iraqi banking system contains 70 commercial banks, governmental and private. The governmental are Rafidain Bank and Rashid Bank and the Iraqi Bank for Trade (TBI) as well as many specialized banks such as The Agricultural Bank and The Industrial Bank and The Real Estate Bank and The Islamic Bank of Nahrain, also a governmental fund that carries out housing lending is The Housing Fund, which is relatively limited in business and financing capacity and is not covered by the Central Bank's supervision because its loans do not contain a final interest rate.

The private banks are a group of banks with private national capital as well as some branches of foreign banks and their total number are (64) banks until the preparation of this paper. The governmental banks have about 94% of the net deposits of the Iraqi banking system and net assets<sup>4</sup>.

#### **Third: Exchange and transfer money companies:**

The Iraqi market operates about 2000 exchange companies working in the field of mediating the exchange of foreign currencies against the Iraqi dinar. There are financial transfer companies working in the field of transfer of funds to and from the Iraqi market and acts with some control by the Central Bank and represent a modest percentage of net cash flows in the Iraqi market, There are also a parallel markets that do business similar to the competence of these companies without

<sup>1</sup> <https://www.cbi.iq/page/39>, in 18 January 2018

<sup>2</sup> These ratios mean liquidity coverage ratio and net fixed financing ratio, respectively.

<sup>3</sup>This criterion was delayed until 2020 to provide institutional requirements in the Iraqi banking system according to the vision of experts of the Central Bank of Iraq.

<sup>4</sup> <https://cbi.iq/page/37>, opcit , in 19 January 2018.

the ability of the central bank to control them and some of them passes through the exchange and financial transfer companies, but without documented in records controlled by the central bank.

The previous presentation includes the institutional components of units and components that conduct banking and finance operations that are subject to the requirements of Basel Committee decisions and standards<sup>1</sup>.

### Standards of the Basel Committee and the Iraqi banking system:

Interest in the issue of credit risk and liquidity in the Iraqi banking system has emerged late, and currently there are institutional and organizational efforts to work on reviewing the traditions and instructions of Iraqi banking work in view of the vision<sup>2</sup> related to this by the Central Bank in the literature of its cash policy and its management and control the banking system. One of the important mechanisms is the adoption of three Basel decisions and standards, in particular Basel III in order to increase the competitiveness of Iraqi banks, and ensuring the stability of the banking system and ensuring the optimal employment of resources of Iraqi banks. Therefore, the Central Bank has entered into the assessment of the implementation of the decisions of Basel since 2015.

However, the start of the implementation of the standards officially began with the beginning of 2017 and mandatory, in particular LCR, NSFR according to a vision to classify the liquidity risk in the following types:

1 / Financing risk: from various sources when the bank carries out typical financing operations.

2/ Market risk: The bank's ability to sell or mortgage its assets.

3 / Accidental or sudden risks such as sudden withdrawal by customers to their deposits.

The Central Bank has adopted the following formulas to calculate each of the two criteria LCR, NSFR:

$$\text{LCR} = \frac{(\text{HQLA}) \text{ liquidity assets value}}{\text{Net cash outflow for 30 days thereafter}} \geq 100$$

$$\text{NSFR} = \frac{\text{Total stable funding available}}{\text{Total stable funding required}} \geq 100$$

In accordance with these criteria and the method of calculation after the beginning of 2017 Iraqi banks must comply with these standards in order to ensure a high degree of stability in the banking system<sup>3</sup>, as a result, the banks and the Central Bank have started to provide the requirements for applying these standards in a way that ensures the need for implementation of these standards.

It should be noted that the banking system in Iraq and under the supervision of the Central Bank has tried many times the application of many international standards, including the standards of Basel of all copies many years ago, but these attempts in practice are still not fruitful for many reasons we will try to be included and discovered in the next part of this paper which explains what factors and constraints that are behind this situation in the Iraqi banking system, which can be described as a state of non-criteria or a kind of turmoil and non-prevention of instability, which could negatively affect the performance as a unit of the Iraqi national macroeconomic.

<sup>1</sup> As there are other components such as insurance companies and investment companies, as well as the small role they do not enter into the concerns of the central bank of Iraq, in the context of his attempts to implement the decisions and standards of the Basel Committee, for more details can be synonymous: Walid Aidi Abdel Nabi, the financial market in Iraq, the reality and future developments, Directorate General of Statistics and Research, Central Bank Page 1-3.

<sup>2</sup> For more details, see: Ali Mohsen Al-Aalal, From Monetary Stability to Financial Stability and Development Enhancement 1947-2017, Central Bank of Iraq, Baghdad, 2017.

<sup>3</sup> For more details: Control for liquidity risk management in accordance with Basel III decisions, Department of Financial Operations and Debt Management, Central Bank of Iraq, Baghdad, 2017.

## Factors of failure of the Iraqi banking system in implementing the decisions of the Basel Committee:

The application of financial standards, which deal with capital adequacy and other standards<sup>1</sup>, to raise the efficiency of the performance of the banking system in any economy, impedes all obstacles and failure factors. In this regard, we will divide these obstacles and the failure factors for the banking system in its attempts to implement the decisions of the Basel Committee, especially Basel III into internal factors from the Iraqi banking system itself, and other factors from the national environment which deals with this banking system, so that we can come up with a clearer image of the problem of our study as follows:

### A / Internal factors:

**1 / Institutional factors:** where many banks are weak institutional types such as the old and backward methods of management and decision-making, especially governmental banks as well as the rule of family style<sup>2</sup> in the management of most private banks which has been reflected in the departure of these banks as business enterprises from many advanced management methods, which can make them conform to the standards of banking management, headed by the Basel Committee, especially Basel III, as well as some institutional weakness in the Central Bank, which represents the role of the director and the first sergeant in the banking system, where it suffers from many institutional weaknesses, especially in the units specialized in the control of financial stability, as these units are new and complain of the manifestations of the government bureaucracy is disabled for its role so far and for internal and external reasons of the Central Bank of Iraq.

It is worth noting that there are many cases of inconsistency in the procedures of some units of the Central Bank with other units due to poor institutional coordination. A low level of independence of the Central Bank institution can be envisaged in terms of policies, programs and procedures for the governmental institution<sup>3</sup>.

**2/** The Iraqi banks do not evaluate the credit and risk and classified according to the degree of risk, but it still depends on the classification which is unscrupulous and taken in exchange for granting uncertain types of guarantees in terms of real estate guarantee in return for granting loans and this type of guarantees in case that the property is personal and individual and taken for personal housing. Therefore, the bank cannot sell it when the borrower fails to pay for the existence of Iraqi legal barriers to prevent this absolutely, so that these guarantees cannot be liquidated as well as personal guarantees are weak types of guarantees and It should be noted that the Iraqi banks achieve an important measure of their profits from purchases from the window sell of the US dollar provided by the central bank, which directs part of its assets to this purpose.

**3/** The joints of the Iraqi banking system from the Central Bank of Iraq to the rest of its banking components complain of low technical capabilities and expertise of the administrative and technical staff and control, especially in the middle and lower levels as well as some higher departments and this result either from the low level of performance evaluation of employees or low level of training programs or indifference and seriousness of the banking departments and administrative levels, the middle and the low level in both negative and positive motivation, as well as the adoption of inherited methods in the banking system that belongs to historical reasons has made the Iraqi economy closed for decades and away from the new bank management and finance knowledge<sup>4</sup>

**4/** There are other administrative and logistical problems related to the banking services of infrastructure, communication networks, information transmission and types of buildings intended for banking are a relatively backward year compared to international standards. This necessarily affects the efficiency of performance and attempts to implement international standards such as Basel III.

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<sup>1</sup> It should be noted that the implementation of Basel III will lead to lower capital adequacy ratios for all Iraqi banks except for newly established banks. Basel II and Basel II are currently taking credit risk into account only, unlike Basel III, which takes into account market risk, credit and operational risk.

<sup>2</sup>Walid Aidi Abdul Nabi, The Iraqi Central Bank and the evolution of its oversight and monetary role and directions of his strategic plan, the Central Bank of Iraq, Baghdad.

<sup>3</sup> Walid Aidi Abdul Nabi, Central Bank of Iraq and the evolution of its oversight and monetary role and the directions of his strategic plan, the Central Bank of Iraq, Baghdad Page 6-7, and Abdul Moneim Alsayd Ali, Independence of central banks with special reference to the Central Bank of Iraq, , No. 57-58, 2012, p. 145.

<sup>4</sup> For more details: (Azhar Abid Sabbar, The impact of the Iraqi banking system in economic growth and the requirements of the coefficient of monetary stability for the period (2000-2012), Journal of Administration and Economics and the University of Karbala, No. (11), Volume (3), 2014, page 268..

## **B/ External factors:**

**1/ Legislation and its negative impact :** It can be noted through a careful study of the Iraqi legislative system related to the management and control of the banking system as well as the general legislative system, in general and in the current situation are complaining of some cases of conflict and clash and does not provide a legal structure to protect the parties of the financial process administered by the banking system legally ,therefore, there can be legal gaps which are the main reasons for the evasion of banks from the central control and the inevitability of the application of international standards, especially the implementation of the Basel III standards, which necessarily need a specific legal style to support its application in an integrated manner<sup>1</sup>.

**2/ General economic situation:** The general economic situation is complaining from the unilateralism of the economy by relying on the oil sector to generate gross domestic product and national income. This situation leads to the stagnation of the banking system and the decrease in investment demand on credit, which leads banks to search for unsecured and high risk types of credit demand, including consumer credit demand.

**3/** The absence of a national payment system that provides a database for the concerned institutions, especially the Central Bank, to study and evaluate the extent to which the banking system's institutions comply with the basic standards, including the standards of the Basel committee when it starts to apply as it now, which is leading to the provision of misleading and deceptive data to the Central Bank<sup>2</sup>, and this continues to lead to a high difficulty in implementing the decisions and standards of Basel copies as well as Basel III which is the subject of paper.

**4/** The phenomenon of administrative and financial corruption where Iraq is witness as an inherent phenomenon of corruption in public and private institutions, which confuses all the regulatory measures, including the possibility of adopting standards of efficiency in the management of the financial process in the banking system because this phenomenon affects a negative outputs which certainly against the standards of efficiency and accounting in accordance with international banking standards such as Basel standards.

**5/** The decline of the ability of public authorities to impose the law in many areas and sectors because of the weakness of prestige and control of the state, which led to a volatile security situation in many areas of Iraq and this certainly affects the commitment of the banking system of the law in addition to the decline of the ability of banks to meet the requirements of banking management disciplined and efficient security environment troubled, because the general situation affects negatively and positively on any economic work, especially banking because of the sensitivity of banking when the security situation in any country in the world.

**6/** The lack of an integrated financial market in Iraq both in the economic and financial sections in the country .The most important institutions that lack in the financial market in Iraq are companies specializing in credit assessment and credit guarantee. In general, the financial market in Iraq is a primitive market and does not rise to the duties and tasks that must be done by any integrated financial market.

**7/** The lack of faith of decision makers in the political authority on the subject of the independence of the Central Bank, leading to practices and pressures led to the failure of many of the duties of the Central Bank as a result of this as well as the possession of banks by some influential political forces led to influence on the general policy of the Central Bank of Iraq and its capabilities in the implementation of standards of efficiency and management banking such as Basel III and similar standards whether it was Iraqi or international standards.

## **The conclusion**

Based on what is presented in this paper, we can include the concluding observations so that we can conclude what is the behavior of our problem, namely, the failure of the Iraqi banking system to implement the Basel III standards until now, as the issue is based on the following trends: first, what are the criteria of Basel? .And how they match the reality of the device bank system now? , it is a matter of risk measurement because Basel III focuses on measuring the market risks, credit risks and operational risks altogether. This is what Iraqi banks cannot meet because they apply the Basel I which measure the credit risk only and the banking system cannot met it alone. Therefore, it is safest to wait for the Basel III application.

<sup>1</sup> For more details: Judicial supreme Council on its website (Iraqi legislation database) [http://www.iraqlid.id/identity\\_search.aspx](http://www.iraqlid.id/identity_search.aspx).

<sup>2</sup> For more details: Central Bank of Iraq, Monetary Policy Report of the Central Bank of Iraq for the years 2012 and 2013, the Central Bank of Iraq, the monetary policy report of the Central Bank of Iraq for the first quarter 2014.

The practical reasons for the failure of the banking system in the application of the Basel standards are reasons that arise from within the Iraqi banking system and are concentrated in the institutional weakness and its unfavorable to the application of international standards such as Basel III in addition to weak assessment of risks and inaccuracies in the selection of guarantees for credit as well as administrative and logistical problems that play a role as one of the reasons for internal failure of the Iraqi banking system in the application of Basel III.

There are objective reasons come from the general environment in Iraq related to the political, legal and economic aspects such as the poor legislation and the economic system, the low capacity of the authorities in the implement of the law and the influence of politicians as well as the important issue which is the lack of integration of the financial market. The financial market is not integrated and does not play its role in line with its role model, as well as the absence of an automated payment system that provides financial information and data to regulatory bodies headed by the Central Bank to be able to apply international standards for banking. All these things affect the ability of the central banking system and banks to implement the Basel III standards which, when applied, can lead to more efficiency of the Iraqi banking system and to use it in the financing, banking and all related disciplines.

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