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Financial safety indicators for the Iraqi banking sector from 2005 to 2018

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Abstract:*Financial safety indicators were considered indicators of financial safety, evaluates and monitors the strengths and weaknesses of financial systems, and the great importance of relationship of banks with supervisory policy , the development of banking supervision was linked to developments in the banking activities, the banking institutions in Iraq was importance of special legislation has been drawn up, started from defining the bank and how to establish, also set supervisory standards for early warning used to measure the banking safety performance, these parameters were taken as indicators to assess the performance of banks and discover errors in order not to fall into financial problems that lead to collapse.*

Keywords: *Financial safety indicator, Iraqi banking sector.*

1. Introduction

Financial safety indicators provide insight into the country's financial institutions safety, financial safety indicators were a new branch of economic statistics that deals with economic measurement disciplines, depended on advanced and supervisory financial accounting concepts to monitor the status of individual financial institutions and information related to the banking sector and macroeconomic indicators, based on economic statistical measures, taking into consideration the conceptual framework of developments in national accounting systems related to international and organizational accounting.

The importance of studying

This research studies one of the important banking models for monitoring the performance of banks by central banks, and evaluate its performance to obtain specific indicators that protect the banking system from the possibility of exposure to financial problems and crises.

Research problem: -

1. How can the central bank achieve to safety financial goal.
2. How to identify potential strengths and weaknesses in banks.

Research goal

1. Determine the indicators of financial stability and safety financial of the banking system and how to measure it.

2- Measuring the impact of safety financial in maintaining financial stability.

Research hypothesis

The research starts from a hypothesis, that testing indicators of financial soundness, it was a useful tool for measuring the ability of the banking sector to cope with the trend of financial turmoil, by classifying banks into stable and unstable banks, based on financial health indicators.

Research Structure

The research was divided into two main axes, preceded by the methodology and followed by conclusions and recommendations. The first axis dealt with the theoretical framework of financial safety. The second axis is concerned with analyzing the reality of financial stability, depending on financial indicators and ratios.

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The first axis: the conceptual aspect of financial safety:

Many writers and researchers have dealt with the concept of financial soundness from multiple viewpoints, some may see it as a “focused evaluation of the bank’s operations and activities through risk control”. Eakins & Mishkin, 2000: 523).

This view reflects the great focus on risk management in banks. It was made clear that there are four factors for managing risk in a proper form, which include:

1. The quality of the conditions for supervision and control by the bank’s board of directors.
2. The adequacy of policies and limits for all activities that contain significant risks.
3. The quality of risk control and supervision systems.
4. Adequacy of internal control to prevent fraud and prohibited activities by some users.

Financial soundness was defined as "the specialized assessment of the stability of the financial system in order to determine the state of any weakness present in it in any period of time (Hadad, 2006: 103)."

The previous definition refers to the function performed by the regulatory and supervisory authorities whose objective is integration in achieving the stability of its financial system.

The second axis: Financial Soundness indicators (FSIs)

To avoid falling into financial crises, could infect financial systems, which leaves negative impacts on the economies of these countries, international financial organizations such as the International Monetary Fund have started working on deriving financial health indicators at the macroeconomic level, to be an early warning sign of the sensitivity of financial sectors exposure to crises, these indicators include many aspects (asset quality, capital adequacy, profitability and liquidity).

First: Capital adequacy ratio indicator:

1. The ratio of capital adequacy for government banks for the period (2005-2009), it ranged from a minimum (0.2%) to the highest (77%) for the year 2006, according to the Basel standard, it is noted that the percentage of some banks, especially the Rafidain Bank, was less than the legal percentage of (12%) (Financial Stability Report, 2006: 8), therefore, some government banks whose rates were less than the standard rate are considered, banks are risky in granting credit and are exposed to significant risk.
2. After that, the percentage for government banks ranged 38-63% for the period 2015-2018, this was due to the lower risk-weighted assets inside and outside the budget, in return, increasing the capital of banks, as this calculated percentage reflects improvement and good financial capacity of government banks that helps them face potential risks, as this percentage is greater than the standard rate set by the Central Bank of Iraq of 12%.
3. As for the capital adequacy ratio for private banks for the period 2005-2009, it ranged from 8-2423%, the total ratio for the banks themselves ranged from 30-323% for the period 2010-2018, which is higher than the legal percentage set by the Central Bank, which was 12%, most of the private banks have reached more than 60%, due to their reservations about granting credit, as a result, high liquidity exceeds the standard ratio of 30% (Financial Stability Report, 2014: 5), this indicates the existence of disrupted financial resources that do not have safe and sound credit and investment opportunities.
4. The capital adequacy ratio of private banks compared to the ratio of government banks for the period 2005-2018 is very high, was exceeding the percentage specified by Basel standards of 8%, as well as specified by the Central Bank of Iraq amounting to 12%, due to four factors: (Financial Stability Report 2018: 34):

a. The first factor: that most of the private banks are newer than government banks, as they were very old, as the capital of the former is high compared to the latter, the risk-weighted assets are high, therefore, it is noticed that there is a gap between the capital adequacy ratio of government banks and private banks in favor of the latter,This difference reflects that the total capital of private banks was high compared to government banks.

b. The second factor: that the number of private banks is more than government banks, the number of the first is 64 banks, while the number of government banks is 7 banks until 2018.

c. The third factor: the increase in the private bank’s capital in response to the directives of the Central Bank to increase the capital, so that the minimum was 250 billion dinars.

Table 1. Capital adequacy ratio for banks operating in Iraq during 2005-2018.

Years	Capital adequacy ratio in government banks%	Capital adequacy ratio in private banks%	Assessed percentage
2005	0.3-76	8-329	12
2006	0.02-72	34-2423	12
2007	1.7-57	13-198	12
2008	0.2-64	15-571	12
2009	0.08-77	8-409	12
2010	2	60	12
2011	2	30	12
2012	2	30	12
2013	2	30	12
2014	3	54	12
2015	46	113	12
2016	63	137	12
2017	38	323	12
2018	43	309	12

Source: Central Bank of Iraq, General Directorate of Statistics and Research, Financial market Research Department, Annual Reports on Financial Stability in (2005-2018).

Second: Asset quality indicators:

The quality of assets constitute the cornerstone of the level of credibility of capital ratios, because most of the risks of financial insolvency in financial institutions were often caused by the quality of the assets or the difficulties of converting them into liquidity when needed, there were many indicators by which quality can be measured, including:

2. Non-performing loan ratio / total cash credit:

Non-performing loans at Iraqi banks recorded 4.88 trillion dinars in 2018, higher than in 2005, which amounted to 18.2 trillion dinars, as a result, the ratio of non-performing loans to cash credit increased from 2.19% in 2005 to (12.6%) in 2018, affects the financial stability index in Iraq, the ratio of non-performing debts is one of the variables included in its calculation.

Non-performing loans were distributed for 2018, by 3.3 trillion dinars for government banks, and 11% of cash credit, 1.5 trillion dinars for private banks and a rate of 21% of cash credit, this indicates that private banks were more exposed to the risk of non-payment compared to government banks, due to the high ratio of its non-performing loans to cash credit compared to government banks.

Table 2. the percentage of non-performing loans / total cash credit during 2005-2018.

Years	Non-performing loans	Cash credit	Non-performing loans / cash credit%
2005	18.2	8.3	2.19
2006	11.3	9.3	1.18
2007	14.3	3.35	4.26
2008	33.4	9.6	3.47
2009	24.2	5.3	4.56
2010	29.7	9.4	3.15
2011	45.9	13	3.53
2012	49.7	20.8	2.38
2013	19.9	30	6.33

2014	23.6	34.1	6.74
2015	30.7	36.8	8.34
2016	33.4	37.2	8.87
2017	43.4	37.9	11.4
2018	4.88	38.5	12.6

Source: Central Bank of Iraq, General Directorate of Statistics and Research, Financial Market Research Department, Annual Reports on Financial Stability in (2005-2018).

Non-performing loans ratio / total assets:

The ratio of non-performing loans (doubtful debts) to the total assets of the banking system in general increased during 2018, as shown in Table (3), as the percentage reached 3.36% compared to 0.86 in 2005, with an increase rate of 82%, this percentage reflects the increase in the banking system, despite increase in 2018, the percentage increased as a result of the increase in the volume of non-performing debts from 1.8 trillion dinars in 2005 to 4.8 trillion dinars in 2018, however, despite its height, reflects a good and sound position of banks operating in Iraq in terms of the size of assets in 2018.

As the literature and international experience indicate that exceeding this percentage (10%) heralds an expected banking crisis, but in Iraq, this percentage was still within acceptable standards, and that reducing it is better and reflects good performance for banks.

Table 3. The ratio of total non-performing loans to total assets during 2005-2018.

Years	Non-performing loans	Total assets	Non-performing loans / total assets
2005	18.2	208.2	0.86
2006	11.3	265.4	0.41
2007	14.3	277.5	0.50
2008	33.4	304.7	1.08
2009	24.2	334.2	0.72
2010	29.7	363.3	0.79
2011	45.9	143.8	3.13
2012	49.7	190.9	3.12
2013	19.9	229.9	0.83
2014	23.6	226.8	1.04
2015	30.7	222.9	1.38
2016	33.4	221.2	1.51
2017	43.4	156.4	3.90
2018	4.88	145.18	3.36

Source: Central Bank of Iraq, General Directorate of Statistics and Research, Financial Market Research Department, Annual Reports on Financial Stability in (2005-2018).

3. Third: Revenue and profitability indicators:

1. The rate of return on assets

The return on assets ratio decreased to 0.53% at 2018, compared with the percentage of 0.57% at the end of 2005, with regard to banks in general, this is a result of the decline in bank profits, the net interest bearing income increased from 655,000 million dinars at 2005 to 1,319,451 million dinars in 2018, likewise, interest-free income decreased from 28,336,608 million dinars at 2005 to 934,509 million dinars in 2018. (Financial Stability Report, 45: 2018). The effect of a decrease in this ratio will destabilize its financial return.

Table 4. the rate of return on total assets during 2005-2018.

Years	The rate of return %	Total assets	Return / asset ratio
2005	1.2	208.2	0.57
2006	4.8	265.4	1.80
2007	5.5	277.5	1.98
2008	1.06	304.7	0.34
2009	8.4	334.2	2.51
2010	7.6	363.3	2.09
2011	9.3	143.8	0.64
2012	1.5	190.9	0.78
2013	1.4	229.9	0.60

2014	1.2	226.8	0.52
2015	1.05	222.9	0.47
2016	1.1	221.2	0.49
2017	1.3	156.4	0.83
2018	6.6	122.9	0.53

Source: Central Bank of Iraq, General Directorate of Statistics and Research, Financial Market Research Department, Annual Reports on Financial Stability in (2005-2018).

2. The rate of return on owners' equity

Table (5) show that the rate of return on property rights reached 14.8% at 2005, then increased until it reached its highest rate in 2012, which was 25.4%, after that, the percentage decreased until it reached 4.37% at 2018, this ratio reflects the rate of return that capital investors get in the financial institution and the efficiency of the institution, and how successful it was in generating profits from each unit of owners' equity, the main reasons for this decrease in the value of income and the increase in the value of assets, the low rate of return leads to fewer financial investors, the bank's capital will decrease on the financial stability of the banking sector.

Table 5. The rate of return on owners' equity during 2005-2018.

Years	The rate of return%	capital	Return / Owners Equity Ratio
2005	1.2	2.5	4.8
2006	4.8	4.4	10.9
2007	5.5	6.3	8.73
2008	1.06	4.1	25.9
2009	8.4	2.3	3.65
2010	7.6	2.8	27.1
2011	9.3	3.9	23.8
2012	1.5	5.9	25.4
2013	1.4	7.7	18.2
2014	1.2	9.1	12.1
2015	1.05	10.1	10.4
2016	1.1	11.7	9.4
2017	1.3	14.3	9.09
2018	6.6	15.1	4.37

Source: Central Bank of Iraq, General Directorate of Statistics and Research, Financial Market Research Department, Annual Reports on Financial Stability in (2005-2018).

4. Conclusions:

1. Despite the decrease in the capital efficiency ratio to below the approved rate of (12%), and the low financial adequacy, governmental commercial banks enjoy the confidence of individuals as banks entrusted and guaranteed by the government (the strong owner) and that the possibility of bankruptcy is very remote.
2. Weakness of effective control methods and procedures that guarantee the provision of a minimum level of disclosure and transparency for dealers.
3. Weakness of the database or its limitations in some companies, which does not help the investor in making a quick and safe investment decision.

Recommendations:

1. It is necessary to adopt a larger and more comprehensive set of indicators and ratios, which effectively express the state of financial stability, and take into account the specificity of the Iraqi banking system.
2. The necessity for the Central Bank of Iraq to issue instructions to banks to organize and use modern banking technologies in their businesses, including comprehensive banking systems, automated teller machines, credit cards and others, and to provide the General Directorate of Banking and Credit

Monitoring with a semi-annual report on the development of their banking technologies and their adoption as a positive indicator within the banks 'evaluation system. .

3. The need for banks to avoid relying on excessive financial leverage, which would increase debt burdens, including interest, and thus weaken their ability to pay off obligations when they are due.

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