



## The Iraqi Legislations Regulating the Granting of Credit Facilities

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### Article Info

**ISSN (Online):** 2582-7138

**Impact Factor (RSIF):** 8.04

**Volume:** 07

**Issue:** 02

**March-April 2026**

**Received:** 17-02-2026

**Accepted:** 16-03-2026

**Published:** 15-04-2026

**Page No:** 568-579

### Abstract

The pivotal role of the banking system in strengthening and developing the macroeconomy is undeniable, given its active contribution to supporting various productive and service sectors, including industry, agriculture, and services. Economic activity in any country revolves around two fundamental axes: the first is real productive activity, and the second is the financial flows necessary to finance the production process. In this context, banking institutions act as financial intermediaries between these two axes through the diverse credit facilities they provide. Banks attract savings in the form of deposits across various savings instruments and with varying maturities. They then direct a portion of these funds towards diverse investment opportunities, while allocating the majority to granting loans and financing to clients, thereby supporting multiple economic activities and bolstering economic development.

**DOI:** <https://doi.org/10.54660/IJMRGE.2026.7.2.568-579>

**Keywords:** Credit Lending Facilities, Credit Risk, Economic Legislation

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### 1. Introduction

The pivotal role of the banking system in strengthening and developing the macroeconomy is undeniable, given its active contribution to supporting various productive and service sectors, including industry, agriculture, and services. Economic activity in any country revolves around two fundamental axes: the first is real productive activity, and the second is the financial flows necessary to finance the production process. In this context, banking institutions act as financial intermediaries between these two axes through the diverse credit facilities they provide. Banks attract savings in the form of deposits across various savings instruments and with varying maturities. They then direct a portion of these funds towards diverse investment opportunities, while allocating the majority to granting loans and financing to clients, thereby supporting multiple economic activities and bolstering economic development. The credit policies adopted by banking institutions are the cornerstone of financial planning, especially since credit facilities provided to customers carry a degree of risk. Although banks generate high profits from lending operations, they are also exposed to significant potential credit risks as a result of granting these facilities.

Given that granting bank credit involves multiple risks, primarily those related to the borrower's ability to repay the principal and interest within the specified timeframes, the decision to grant credit is one of the most complex decisions for which bank management bears responsibility. This is especially true in light of the increasing competition among banking institutions in the field of credit financing, which necessitates competent bank management capable of addressing these challenges, balancing deposit and loan volumes, and mitigating the credit risks associated with borrowers.

States support banking institutions in this regard by establishing an integrated legal framework governing the granting of credit facilities, as well as by enacting regulatory legislation aimed at controlling such facilities to ensure their alignment with the State's economic policies.

In furtherance of this objective, the Central Bank of Iraq Law No. (56) of 2004 incorporates a number of provisions relating to banking credit facilities. Additionally, the Credit Information Exchange Instructions of 2014 were issued pursuant to the provisions of paragraph (3) of Article (4) of the amended Central Bank of Iraq Law No. (56) of 2004, and paragraph (A) of Article (104) of the Iraqi Banking Law No. (94) of 2004.

**From this perspective, this research addresses the Iraqi legislations regulating the granting of credit facilities through the following points**

#### **First: The Importance of the Research**

The significance of this research stems from its focus on elucidating the magnitude of risks that banks may encounter as a result of the increasing volume of non-performing loans arising from credit facilities. Such risks extend beyond the banking sector, producing adverse repercussions on the national economy. This, in turn, necessitates the establishment of a protective legislative framework designed to safeguard banking institutions.

#### **Second: The Objective of the Research**

The existence of a well-integrated banking sector that provides the necessary financing—whether to institutions, individuals, or, at times, the government—contributes significantly to enhancing investment and driving economic growth. There exists a positive correlation between the rate of economic growth and the volume of credit extended by the financial and banking system.

In light of the risks associated with loan default that banks may face as a result of credit facilities, it becomes imperative to establish a regulatory legal framework governing such transactions. Accordingly, this research primarily aims to examine the Iraqi legislative framework regulating banking credit operations and to assess its role in safeguarding the national economy as well as protecting banking institutions from the problem of non-performing loans.

#### **Third: Research Problem**

Banking credit constitutes a significant and influential factor in promoting economic growth, as financial institutions provide banking services to both depositors and investors. However, this process is accompanied by the risk of non-performing loans. Accordingly, the core problem of this research is represented as follows:

1. Do banks possess the capacity to mitigate non-performing loans?
2. Do governmental legislative frameworks provide adequate protection for banks in addressing the problem of non-performing debts?
3. Do banks adhere objectively to the regulations governing the granting of credit?

#### **Fourth: Research Hypotheses**

Based on the presentation of the research problem, its significance, and its objectives, the following main hypothesis has been formulated:

Governmental legislative frameworks contribute to mitigating the phenomenon of non-performing loans arising from banking credit operations.

From this main hypothesis, the following sub-hypotheses can be formulated:

- The extent to which credit management departments within banks are capable of mitigating non-performing loans.
- The extent to which credit management departments comply with the requirements governing the granting of credit.
- The extent to which credit management departments adhere to the legislative framework regulating banking credit operations.

#### **Fifth: Research Methodology**

The study adopts the descriptive-analytical approach, as it is considered the most appropriate methodology for such research. This is achieved through a comprehensive review of the relevant literature, as well as the presentation and subsequent analysis of the legal provisions pertinent to the subject of the study.

#### **Sixth: Previous Studies**

Al-Nuwairi (2010), entitled "Loan Default and Its Impact on the Financial Performance of Commercial Banks in Sudan": This study aimed to examine the causes of loan default and its impact on the overall economic conditions in general, and on the banking sector in particular, with specific reference to banks operating in Sudan.

- The study concluded that the widespread occurrence of loan default is attributable to several factors, including :
- The absence of clear credit policies, which has led to inaccurate and inequitable valuation of collateral; in addition to deficiencies in the flow of information concerning clients, and the weak performance of human resources within the banking sector.
- The study concluded with several recommendations, the most significant of which are:
- The necessity of employing qualified and reliable expertise to assess the collateral provided by borrowing clients.
- Al-Arbeed (2007), entitled "An Analytical Study of Non-Performing Loans in the Iraqi Industrial Bank":
- This study aimed to analyze the relative significance of non-performing loans and to examine their development over the period from 1998 to 2005. This was conducted through an analytical study applied to the Iraqi Industrial Bank, relying on financial data, and by reviewing the measures adopted by the bank to address non-performing loans.
- The study concluded that the Iraqi Industrial Bank exhibits deficiencies in the preparation of credit studies, as well as a lack of continuous field monitoring of clients' activities following the granting of loans, which has led to the default of credit facilities extended to certain clients.
- The study further recommended the necessity of continuous field monitoring of clients' operations, in addition to the importance of utilizing financial analysis indicators for the early prediction of potential client default. It also emphasized the need to conduct objective credit risk analysis through the reassessment of tangible collateral and ensuring its alignment with the purpose for which the credit was granted.
- Chiang , Y. and Cheng E. " 2010 " , Revealing bank lending decisions for contractors in Hong Kong .

This study aimed to explore and understand commercial banks' perceptions of the lending process to contractors in Hong Kong. The researcher sought to identify the factors that assist commercial banks operating in Hong Kong in making lending decisions in favor of contractors, and to determine the variables that constitute the evaluation criteria. Initially, a set of financial and non-financial factors was identified based on previous studies, which were then applied to a sample of borrowers.

The researcher developed a model for evaluating borrowers

based on the previously identified variables, with the aim of assisting banks in making lending decisions. The study also concluded that the lending policies adopted by commercial banks in Hong Kong are consistent with internationally recognized practices.

Adel Hebal (2012), entitled "The Problematic of Non-Performing Bank Loans: A Case Study of Algeria":

This study aimed to identify the causes of debt default in Algerian primary banks. It concluded that the phenomenon of non-performing loans cannot be entirely eliminated; rather, its scale can be reduced and its effects mitigated. The study further found that improper decisions in granting credit facilities lead to significant losses for banks, and emphasized the necessity of monitoring the collateral provided to banking institutions.

Among the most important recommendations put forward by the study are:

The need to adopt modern information systems for risk management.

The necessity of ensuring the availability of qualified competencies and expertise to implement new standards and frameworks for risk measurement in accordance with international standards.

The need to adopt more effective information flow systems, such as the implementation of credit scoring systems.

Based on the foregoing, this study is structured into five main sections, each contributing to addressing the research questions. Each section is further subdivided into explanatory and analytical points, as outlined below:

Section One: The Concept and Objectives of Credit Policy.

Section Two: Determinants of Credit Policy.

Section Three: General Rules Governing the Granting of Credit Facilities.

Section Four: The Balance Between Return and Credit Risk in Granting Credit Facilities.

Section Five: The Iraqi Legislative Framework Regulating the Granting of Credit Facilities.

Finally, the research concludes with a set of results and recommendations

## Section One

### The Concept and Objectives of Credit Policy

The concept of credit policy has been defined in various ways, with its formulation differing according to the perspectives of researchers. Some scholars define it as: "the general framework encompassing a set of principles, standards, and guiding orientations adopted by bank management in general, and credit management in particular, in achieving their objectives and making credit-related decisions."

It may also be defined as: "the general framework that includes a set of principles and controls governing the procedures for the assessment, granting, approval, and monitoring of credit facilities, while specifying the sectors eligible for financing, along with the associated credit limits, costs, and timeframes that should not be exceeded, in addition to the conditions required for each type of such facilities <sup>[1]</sup>."

Accordingly, credit decisions within banking institutions should be made within the framework of the adopted credit policy objectives, which may vary from one bank to another depending on the specific circumstances of each institution. This policy represents a set of regulatory controls governing the bank's activities in granting credit facilities.

In another definition, a bank's credit policy is described as: "the general framework encompassing a set of principles and rules governing the procedures for the assessment, approval, granting, and monitoring of credit, while specifying the sectors eligible for financing, together with the associated credit limits, costs, and timeframes that should not be exceeded, in addition to the conditions required for each type of credit <sup>[2]</sup>."

This field has also witnessed the development of numerous models designed for the measurement of credit risk and credit rating.

In the same context, reference should also be made to the definitions of both credit strategy and credit procedures.

- **Credit Strategy:** "Credit strategy represents the general framework or principal orientation adopted by a banking institution to achieve its objectives in both the short and long term. This strategy operates within the broader national credit strategy established by the central bank at the macroeconomic level."
- **Credit Procedures:** "Credit procedures are defined as the set of detailed processes and technical analytical methods adopted within the framework of implementing the bank's credit policy. They constitute a sequence of procedural stages that address the credit process from the submission of the client's application for credit facilities, through the various stages of assessment and approval, and culminating in the repayment of the principal amount and the interest due to the bank <sup>[3]</sup>."

### First: Controls of Credit Policy

Based on the foregoing review of the definitions of credit policy, a set of controls and considerations governing credit policies can be derived, the most prominent of which include <sup>[4]</sup>

1. **Economic Activity Requirements:** Credit policies adopted by banking institutions should not be absolute or devoid of regulatory controls; rather, they must be directed in a manner that serves the national economy and contributes to its growth and stability. Accordingly, the credit policy should reflect the needs of the community within which the banking institution operates.
2. **Loan Size and Types:** Clear accounting and financial standards should be established and adhered to by banking institutions when granting credit, including considerations such as the volume of deposits, available resources, and the nature of the loan. Given that credit operations inherently involve a degree of risk, each bank must adopt a clear and well-structured policy for loan issuance. It should be noted that such policies may vary from one banking institution to another depending on

<sup>1</sup> Hassan Hussein Qalla and Moayad Abdul Rahman Al-Douri, Bank Management: A Quantitative Approach and Contemporary Strategy, Wael Publishing House, Amman, Jordan, 2003, p. 126.

<sup>2</sup> Chen, Xiaohong A., Xiaodhig Wang A, Desheng Dash Wu B. @ 2010 @ , Credit risk measurement and early warning of SMEs : An empirical study of listed SMEs in China , Decision Support System , Vol. 49, No. 10 , P. 301 – 310 .

<sup>3</sup> Hamza Mahmoud Al-Zubaidi, Bank Credit Management and Credit Analysis, Al-Warraq Publishing and Distribution, Amman, 2002.

<sup>4</sup> Khalid Waheeb Al-Rawi, Banking Operations Management, 3rd ed., Dar Al-Manahij for Publishing and Distribution, Amman, Jordan, 2003, pp. 166–167.

- their respective circumstances and capabilities.
3. **Loan Conditions:** These comprise a set of terms relating to the repayment mechanism, the purpose of the credit, and the collateral provided by the borrower. Such conditions constitute binding controls that the bank may not exceed or disregard.
  4. **Determining Loan Soundness Requirements:** Although credit policy generally aims to achieve profitability for the bank, this objective should not be pursued at the expense of the desired level of safety and stability. Accordingly, credit management within banking institutions must ensure the presence of a set of borrower-related criteria that contribute to safeguarding the soundness of credit, such as creditworthiness, personal characteristics, and financial capacity, in proportion to the size of the loan or the credit facility granted<sup>[5]</sup>.
  5. **Legal Considerations:** These include a set of legal conditions and constraints associated with the granting of credit, ensuring that the bank's adopted credit policies do not conflict with the legislative framework governing banking activities, as well as with the regulations and policies imposed by the monetary authority.

#### **Second: Objectives of Credit Policy**

The primary objective of establishing a credit policy is to provide a general framework and specific criteria to guide credit officers in making decisions regarding the granting or denial of banking credit. It also serves as an effective tool that enables management to define its objectives, plan accordingly, and exercise control over their implementation. The availability of such criteria contributes to achieving unity and consistency in operations within the bank, whereas their absence may lead to inconsistencies in decision-making standards. Accordingly, credit policy pursues multiple objectives, the most prominent of which will be examined in this study<sup>[6]</sup>.

1. Although banking institutions enjoy a degree of autonomy in formulating their credit policies, such policies must be aligned with the state's general financial policy as issued by the central bank, and consistent with economic development plans. Accordingly, banks' credit policies should support and reinforce the state's economic orientations.
2. Credit constitutes one of the principal sources of revenue for banking institutions. To achieve a high level of profitability, banks must operate along two parallel tracks: maximizing returns and minimizing losses. This, in turn, positively reflects on the bank's market value, as a result of the strength and soundness of its financial position.
3. The bank's credit policy should be based on clear and well-defined foundations applicable to both credit management and clients, thereby contributing to the avoidance of conflicts or inconsistencies in the credit decision-making process.
4. **Priority Sectors in Lending:** Each banking institution adopts a lending policy through which it seeks to achieve its general objectives and mission. Accordingly, it may identify specific sectors or activities to which it grants

priority in financing. As a result, banks may be required to rationalize their credit decisions and direct them toward financing particular activities rather than others, with the aim of maintaining the quality and soundness of the credit granted.

5. **Restricted Credit Sectors:** Banking institutions may designate certain credit areas as prohibited for financing, whether for legal, ethical, or environmental reasons, or due to the high level of risk associated with such activities. Regardless of the underlying rationale, the bank's credit policy may include a list of sectors or activities that are not permitted to receive financing.

#### **Section Two**

##### **Determinants of Credit Policy**

Credit determinants are defined as a set of controls and conditions established by the authorities regulating economic activity within the state, with the aim of organizing credit operations. In the banking sector, the monetary authority formulates these determinants in light of the significance of credit and its vital role in economic activity, as well as its impact on achieving various economic objectives, including the protection of depositors' funds, the maintenance of currency stability, the control of the general price level, and the stimulation of economic activity while addressing periods of recession.

Banking institutions that grant credit may also establish such determinants with the objective of minimizing credit risk to the greatest possible extent, ensuring the recovery of their financial rights, maximizing shareholders' equity, and maintaining adequate levels of liquidity.

There are a number of factors that should be taken into account when formulating credit policy, noting that these factors are numerous. Some are related to each banking institution and its own policies, while others relate to the country's circumstances, public policies, and prevailing economic conditions, which can be summarized in the following points:

1. **The monetary policy pursued by the central bank:** Which has a direct and clear impact on credit policies, whether with regard to setting interest rates, exchange rates, or trade finance decisions, as well as other legislation and laws regulating the work of banking institutions.
2. **The prevailing economic situation in the country:** This reflects the economic conditions the country is going through, in terms of recessions, as well as inflation levels, unemployment rates, and economic growth indicators.
3. **The degree of risk and profitability associated with different types of loans:** Since every economic activity has a specific level of risk that corresponds to an expected return, the variation in degrees of risk and profitability between different types of loans and financing directly affects the formulation of credit policies.
4. **Legal considerations:** The legislative framework governing banking activities, the instructions issued by central banks, as well as the legal constraints and conditions associated with the granting of credit,

<sup>5</sup> Mounir Ibrahim Hindi, *Financial Institutions Management and Capital Markets*, منشأة المعارف (Mansha'at Al-Ma'arif), Alexandria, Egypt, 2006, p. 100.

<sup>6</sup> Nassar, 2005, pp. 56-57.

constitute key determinants that must be taken into account when formulating credit policies. This ensures that the bank's policies do not conflict with the general credit policy established by the central bank <sup>[7]</sup>.

5. **Volume and Composition of Deposits:** The size and nature of funds deposited with the bank are among the factors influencing the formulation of credit policy. Credit policies tend to be more flexible and expansionary in granting credit when deposit volumes are high or when long-term deposits prevail, whereas they become more conservative and restrictive when deposit volumes are limited.
6. **Size and Composition of Bank Capital:** The size of the bank's capital and the components of its equity directly influence the formulation of credit policy. They also play a central role in shaping its general orientation and defining its fundamental features.
7. **Human element:** The experience and competence of employees in banking institutions are a key factor in preparing credit policy, which requires the availability of qualified and trained human resources who have the necessary experience to manage this policy efficiently and effectively.
8. **Society's need for credit:** Societies' need for credit varies between periods of sufficiency and periods of increasing need, and this need also varies according to the diversity of economic sectors within the society. Therefore, when formulating credit policy, it is essential to consider these needs in their various forms, while achieving a suitable balance between the different economic sectors.

### Section Three

#### General Rules Governing the Granting of Credit Facilities

Societies' need for credit varies between periods of sufficiency and periods of increasing need, and this need also varies according to the diversity of economic sectors within the society. Therefore, when formulating credit policy, it is essential to consider these needs in their various forms, while achieving a suitable balance between the different economic sectors.

Despite the importance of credit facilities granted by banks to their clients, as credit is considered the most attractive investment for banking activity and is a source of high profitability for banks, in addition to the important role that credit plays in the economic development of countries, this process is fraught with a large part of the risks that banks may face in the event that some borrowers fail to pay their debts, and banks may face crises that affect the collection of these debts. Therefore, bank managements must deal with the file of credit facilities according to controls and standards that reduce the percentage of potential risks resulting from granting credit facilities.

#### First: Concept of Credit Facilities

There are many definitions of credit, and different perspectives on it exist. Credit has an economic meaning, which is the ability to lend, and a technical meaning, which is the commitment of one party to another to lend or borrow.

It means that the creditor grants the debtor a grace period of time during which the debtor is obligated to pay the value of the debt. Accordingly, credit constitutes an investment financing mechanism adopted by banks of various types.

Banking credit is defined as a process whereby a bank agrees, in return for a specified return—such as interest or commission—to grant a client, whether an individual or a company, upon request, financial facilities that may be immediate or deferred. These facilities may take the form of cash or other financing arrangements, with the aim of covering liquidity shortages, enabling the client to continue normal business operations, or financing investment purposes. Credit may also take the form of an indirect commitment, whereby the bank undertakes to guarantee or act as a surety on behalf of the client vis-à-vis third parties <sup>[8]</sup>. Some scholars define it as: "the exchange of a present value for a commitment to a future value of equivalent amount, which is typically in the form of money <sup>[9]</sup>."

It is also defined as: "a debtor-creditor relationship established between two parties: the lender, as the provider of financing—whether in the form of money, goods, or services—and the borrower, as the recipient of such financing. This relationship is grounded in the element of trust and creditworthiness between the parties, and entails an obligation on the debtor to repay within a specified period from the date the financing is granted. Such repayment may be fulfilled through successive cash installments over the term of maturity <sup>[10]</sup>."

#### Elements of Credit <sup>[11]</sup>

Based on the foregoing review of the definitions of credit, four fundamental elements upon which this concept is based can be identified and distinguished, namely:

#### Debtor-Creditor Relationship

This relationship is fundamentally based on mutual trust between two parties: the creditor, as the provider of credit, and the debtor, as the recipient of such credit.

#### Existence of Debt

A credit relationship cannot arise without the existence of a debt, which typically takes the form of a monetary amount provided by the creditor to the debtor, with the latter being obligated to repay it upon the agreed maturity date.

#### The term or time difference

A precisely defined time period is required for debt repayment, which is the period between the creation of the obligation and its termination by payment. This time dimension is an essential element in credit, as it distinguishes between instant transactions and credit transactions.

#### Risk

In order for banking credit facilities to be granted within a sound legal and legislative framework, and in accordance with established banking rules and practices, they must be granted according to the following set of controls and

<sup>7</sup> Amjad Izzat Abdulma'zoz Issa, Lending Policy in Banks Operating in Palestine, Master's Thesis, Faculty of Graduate Studies, An-Najah National University, Nablus, Palestine, 2004, p. 53.

<sup>8</sup> Hamza Mahmoud Al-Zubaidi, Bank Credit Management and Credit Analysis, Al-Warraq Publishing and Distribution, Amman, 2002, p. 18.

<sup>9</sup> Zainab Awadallah and Osama Mohamed Al-Fouly, Fundamentals of Monetary and Banking Economics, Al-Halabi Legal Publications, 2003, p. 77.

<sup>10</sup> Abdul Salam Lafta Saeed, Banking Credit, Academy of Graduate Studies and Economic Research, Tripoli, Libya, 2000, p. 17.

<sup>11</sup> Hamza Mahmoud Al-Zubaidi, op. cit., p. 18.

standards:

### Third: Principles Governing the Granting of Credit

In order for banking credit facilities to be granted within a sound legal and legislative framework, and in accordance with established rules and customary banking practices, they must be extended in line with the following set of controls and standards:

**Safety (Security):** Credit facilities should not be granted at the expense of the level of security that banking institutions must maintain, especially since these facilities are a major source of revenue due to the financial returns they generate. However, they also carry risks, namely the possibility of the borrower defaulting on the principal and interest payments on time, which could pose a significant problem for the bank if such defaults exceed acceptable safe limits.

**Profitability:** The main objective of credit facilities is to achieve a suitable profit for the banking institution. Therefore, the return achieved from these facilities must exceed the size of the expenses associated with them, in order to ensure a rewarding return on invested capital.

**Liquidity:** Liquidity shortages are among the most significant challenges facing banking institutions, particularly given their obligation to promptly meet customer withdrawal requests. This necessitates that bank management maintain a safe level of liquidity to fulfill these obligations. However, this may conflict with the bank's pursuit of profit maximization, of which credit facilities are a primary source, requiring a delicate balance between liquidity requirements and profitability considerations.

Based on the above, every banking institution must formulate its credit policies according to these principles and in accordance with market requirements, as these policies serve as a framework that includes a set of standards and guiding controls provided to the departments responsible for granting credit.

This framework ensures a unified approach in handling similar cases, enhances the confidence of personnel, and enables them to perform their duties efficiently without fear of error. It also provides an appropriate degree of flexibility that facilitates prompt decision-making without the need to refer to higher administrative levels, within the limits of the authority delegated to them<sup>[12]</sup>.

### Fourth: Rules Governing the Granting of Credit

The credit study upon which the decision to grant or deny credit is based is closely linked to two principal types of credit analysis:

**Qualitative Analysis:** This aims to assess the borrower's willingness to fulfill their obligations within the agreed timeframes. It is evaluated based on indicators that fall outside the financial statements.

**Quantitative Analysis:** This seeks to measure the borrower's ability to meet their financial obligations within the specified timeframes, relying on data derived from financial statements.

There are several models relied upon by credit management departments in banking institutions to establish sound lending standards and criteria, reflecting the borrower's creditworthiness. Among the most prominent modern models in the field of credit analysis and forecasting is the PRISM model, which aims to identify the strengths and weaknesses of the borrower. This model is based on the analysis of repayment capacity, potential deficiencies, the purpose of the credit, and the collateral provided. It is founded upon the following elements:

**Perspective:** This refers to a comprehensive understanding of the risks associated with the loan and the expected returns therefrom; that is, the ability to identify and analyze the risks and returns related to the borrower, as well as to evaluate the operational and financial strategies that contribute to improving performance and maximizing the market value of equity.

**Repayment Capacity:** This denotes the borrower's ability to repay the loan and its associated interest within the agreed timeframe, through the assessment of repayment sources linked to the operational efficiency of activities in generating the cash flows necessary to meet financial obligations<sup>[13]</sup>.

**The purpose of the loan:** This is fundamental to studying the sector to which the loan is directed, as the purpose of the financing should be clear, specific, and understood by the bank's management, given that one of the most prominent reasons for borrowers' default is using the loan for a purpose other than that for which it was granted.<sup>[14]</sup>

**Collateral:** The collateral provided by the borrower to the bank represents a key element of security in the event of default. Such collateral may be internal—based on the strength of the borrower's financial position—or may take the form of contractual conditions stipulated in the lending agreement. Collateral thus serves as a preventive mechanism employed by banks to mitigate and manage the risks associated with lending operations<sup>[15]</sup>.

**Management:** This refers to the analysis of the managerial methods and procedures adopted by the credit applicant, as well as the evaluation of how the loan is utilized and managed. It also involves the collection and analysis of information related to the characteristics and expertise of the management responsible for overseeing the borrower's operations<sup>[16]</sup>.

## Section Four

### The Balance Between Return and Credit Risk in Granting Credit Facilities

There is a close relationship between the level of profits achieved by banking institutions and the magnitude of risks associated with their investment activities, as well as the extent to which such risks can be mitigated. Nevertheless, certain risks inherent in the prevailing economic environment of financial markets remain difficult to entirely eliminate.

<sup>12</sup> Abdel Ghafar Hanafi and Abdel Salam Abu Qahf, *Modern Management in Commercial Banks*, University Press (Al-Dar Al-Jami'iyya), Alexandria, Egypt, 2004, p. 140.

<sup>13</sup> Abdul Salam Lafta Saeed and Alaa Ihsan Ali, "The Use of the 5S Model in Granting Credit: A Proposed Model," *Journal of the College of Baghdad for Economic Sciences University*, Issue 51, 2017, p. 109.

<sup>14</sup> Ali Abdullah Ahmed Shaheen, *A Scientific Approach to Measuring Banking Credit Risk in Commercial Banks in Palestine: An Analytical Study*, Islamic University, Gaza, Palestine, 2010, p. 12

<sup>15</sup> Abdel Latif Belgharsa, *The Knowledge Resource in Banking Management*, Publications of Badji Mokhtar University, Annaba, Algeria, 2007, p. 172

<sup>16</sup> Mohamed Abbadi, "Evaluation of Trade in Granting Credit: An Analytical Study for the Period 1989–2009," *Journal of Communication in Economics, Management and Law*, Algeria, 2014, Issue 39, p. 34.

Banks are exposed to various types of risks, including liquidity risk, exchange rate risk, interest rate risk, operational risk, and capital risk, in addition to credit risk, which constitutes the central focus of this study and will be examined in greater detail.

### Credit Risk

The Committee on Banking Regulation and Risk Management within the U.S. banking sector defines banking risk as "the probability of incurring losses, either directly through a decline in business performance or a reduction in capital, or indirectly due to constraints that limit the bank's ability to achieve its objectives. Such constraints may weaken the bank's capacity to continue providing its services and conducting its activities, as well as reduce its ability to capitalize on available opportunities within the banking environment<sup>[17]</sup>." The Basel<sup>[18]</sup> Committee defines risk in the banking context as "the probability of incurring losses resulting from inadequate or failed internal processes, including human resources and systems, or from external events leading to damage to, or loss of, fixed assets due to disasters or other unforeseen circumstances<sup>[19]</sup>."

Accordingly, it has become well established in banking practice that there is a need for a specialized department dedicated to credit risk management. Such a department is responsible for identifying, measuring, and assessing various potential risks, and for reporting them to senior management, with the aim of avoiding or controlling such risks and mitigating their effects in a timely manner.

With regard to the risks arising from the granting of credit facilities, it is incumbent upon risk management to assess the adequacy of banks' capital and their liquidity levels by comparing them with the magnitude of risks they face, as well as with prevailing market and economic conditions. This also includes the development and periodic review of contingency plans and procedures, considering the specific circumstances of each bank. Furthermore, credit risk management should be balanced and aligned with the returns generated from the granting of credit facilities.

Credit risk is closely associated with asset quality and the likelihood of default; however, the process of assessing such quality faces significant challenges due to the limited availability of information and the variability in its accuracy. Measures of credit risk primarily focus on loans, given their relatively high default rates. Most indicators rely on the analysis of net loan losses and the volume of non-performing loans, as total loan losses represent the value of amounts that have been written off due to the inability to recover them over a specified period.

Credit risk arises when a bank fails to accurately assess the borrower's ability to meet their obligations relating to the repayment of the principal and interest on the loan. At its

core, the financial decision is based on the determination of two fundamental elements: the expected return and the level of risk, which is commonly referred to as the risk–return trade-off.

The optimal credit decision is one that management considers to achieve a return that is commensurate with, or exceeds, the associated level of risk. On this basis, the direction of credit management activities in decision-making is determined, as this principle is founded on achieving a balance between the variables of return and risk. This balance implies that the expected return from the credit decision should be sufficient to compensate the bank for the potential risks involved. It is upon this foundation that credit management determines the required return in exchange for the funds extended to credit applicants.

Therefore, credit risk analysis is a fundamental pillar upon which bank lending decisions are based. It involves classifying the borrower's creditworthiness and assessing the level of risk associated with the requested loan. Based on the results of this assessment, a decision is made regarding the financing request, either approving or rejecting it. In the event of approval, the terms of credit are determined, including the interest rate and the type of collateral or guarantees to be provided.

Given that any imbalance between return and the credit risks associated with the granting of credit facilities may result in adverse effects on the bank's financial position, it is essential that credit policy be characterized by robustness and efficiency, enabling it to minimize such risks to the lowest possible level.

### Types of Credit Risk

**Liquidity Risk:** This arises in the event of a mismatch between customers' cash withdrawals and their failure to repay due loans.

**Pricing Risk:** This occurs when the bank inaccurately prices its credit products borne by the client, as such pricing should be aligned with the level of risk to which the bank is exposed.

**Execution Risk:** Banking institutions are expected to maintain a comprehensive database of their clients, through which they are classified according to their level of compliance in loan repayment. Such data must be updated periodically and accurately to ensure its reliability and effectiveness.

**Risks of guarantee erosion:** The guarantees obtained by the bank in exchange for granting credit should be strong and robust, so that they are not subject to erosion or a decrease in value under any emergency circumstances, such as fluctuations in exchange rates or changes in monetary policies issued by the central bank.

**Political and legal risks:** It is necessary to follow the legislation and laws issued by the competent authorities in the

<sup>17</sup> Mohammad Dawood Othman, *The Impact of Credit Risk Mitigants on Bank Value: An Applied Study on the Jordanian Commercial and Foreign Banking Sector Using Tobin's Q Model*, PhD Dissertation, Faculty of Financial and Banking Sciences, Arab Academy for Banking and Financial Sciences, Department of Banking, Banking Specialization, Jordan, 2008, p. 54.

<sup>18</sup> The Basel Committee is a technical advisory body that is not founded on any formal international treaty; rather, it was established pursuant to a decision by the Governors of the central banks of industrialized countries. The Committee convenes four times annually and is supported by working groups composed of technical experts who examine various aspects of banking supervision.

The Committee has played a significant role in establishing an international framework for banking supervision and in fostering a common understanding among central banks worldwide, based on coordination among different supervisory authorities and the development of mechanisms to address the risks faced by banks, in recognition of the importance and sensitivity of the banking sector. Accordingly, the Committee has come to represent a cornerstone of international cooperation in the field of banking supervision. Hayat Najjar, *Banking Risk Management in Accordance with Basel Accords: A Study of the Reality of Algerian Public Commercial Banks*, PhD Dissertation in Economic Sciences, Ferhat Abbas University, Sétif, 2014, p. 94.

<sup>19</sup> Tarek El-Gamal, *Risk Management Strategy*, 1st ed., Police Press, Egypt, 2011, p. 9.

country to ensure the legitimacy of the decisions taken by the bank when granting credit, and the political changes that the country is going through should also be considered, as political and security instability constitutes one of the most significant risks affecting credit operations.

**Risks of non-performing loans:** These are credit facilities that the customer obtained from the bank and did not repay within the specified deadlines, which leads to their transformation from a source of revenue for the bank into non-performing debit balances.

### Third: Measures of Risk and Return

The various types of risks that banking institutions may face, which have been previously mentioned, must be assessed through regular descriptive analysis, and they must be quantified whenever possible, considering the impact of expected and unexpected events on these risks. Building a quantitative model to identify, measure, and predict exposure to specific risks is a cornerstone of financial engineering, particularly in its role in risk management. This process relies on employing available quantitative techniques and methods within the scope of operations research, univariate and multivariate statistical analysis, and econometric tools. Regardless of the model used, it must be designed to suit the nature of banking operations and serve its risk management objectives.

A bank's profitability is directly linked to the level of risk associated with its investment portfolio and operations, as well as its ability to mitigate some of these risks. Since risk is an inherent part of banking, it is difficult to eliminate it entirely. However, establishing a comprehensive system and clearly defining the risks associated with banking activities significantly contributes to reducing, predicting, and taking the necessary precautions to address them as much as possible.

### Methods for Measuring Credit Risk

#### Standardized Approach

This approach is primarily based on assigning relative risk weights according to different exposure centers, such as governments, banks, and companies, based on the credit ratings issued by external rating agencies for these entities, as it is responsible for recognizing and approving such agencies as reference bodies relied upon in determining clients' credit ratings, and consequently, the associated risk weights<sup>[20]</sup>.

#### Internal Rating Approach:

Within this framework, banking institutions estimate the probability of borrower default, while the remaining inputs required for the calculation of credit risk are determined by the central bank. This approach results in two main methodologies<sup>[21]</sup>:

**Foundation Approach:** This approach enables banking institutions to assess the borrower's financial soundness based on a set of predefined criteria, whereby the client's creditworthiness is translated into estimates used in calculating potential future losses. These estimates serve as a basis for determining the minimum capital requirements.

**Advanced Approach:** Under this approach, banking institutions rely on their internal models to estimate the probability of default, the magnitude of expected losses in the event of default, as well as to measure the level of credit exposure and the maturity of the granted facilities.

### Section Five

#### The Iraqi Legislative Framework Regulating the Granting of Credit Facilities

The Iraqi banking sector suffers from structural imbalances and faces multiple challenges, as well as market risks arising from the instability of the investment environment. This has negatively affected its level of development and limited its integration into the global banking system. Following 2003, Iraq inherited a deteriorated banking system, manifested in a lack of confidence in domestic banks and a diminished role in supporting economic and developmental activities.

During that period, the Central Bank of Iraq was subject to the authority of the Ministry of Finance, with its primary function limited to issuing currency in exchange for its holdings of government debt instruments, particularly treasury bills, which constituted the largest portion of its assets. This situation is commonly referred to as the phenomenon of "debt monetization." This policy led to an expansion in the money supply and a consequent rise in inflation rates<sup>[22]</sup>.

Accordingly, the need emerged to implement comprehensive banking reforms, particularly with respect to restructuring the banking sector, diagnosing financial, operational, and supervisory deficiencies, and issuing appropriate regulations and directives by the central bank. With the aim of regulating the work of public and private banks and strengthening oversight of them.

To address these challenges, the Central Bank of Iraq Law No. (56) of 2004 was issued, as well as the Banking Law No. (94) of 2004, which allowed foreign banks to operate within Iraq. Based on market economy principles, a number of reform measures were adopted, most notably:

- Cancellation of the annual credit plan that the central bank used to prepare for banks, and granting each bank the authority to develop its own credit plan independently according to its policies and special circumstances.
- Enabling banking institutions to offer syndicated loans of large value, which are financed through the contribution of more than one bank.
- Granting loans based on rigorous economic feasibility studies, while requiring adequate collateral and ensuring that funds are utilized for their intended purposes.
- Adopting credit classification guidelines, along with establishing financial provisions commensurate with the level of risk associated with each credit category, ranging from performing to non-performing credit, thereby ensuring the soundness and stability of banking operations.
- Re-evaluating and updating banking legislation in Iraq with the aim of developing the banking sector, whereby

<sup>20</sup> Naima Khadrawi, *Banking Risk Management: A Comparative Study between Conventional and Islamic Banks – The Case of the Bank of Agriculture and Rural Development and Al Baraka Bank Algeria*, Master's Thesis in Economic Sciences, Specialization in Money and Finance, Mohamed Khider University, Biskra, 2009, p. 113.

<sup>21</sup> Jamal Al-Issani, *Capital Adequacy Calculation for Islamic Banks within the Framework of Basel II Requirements: An Applied Study on Al Baraka*

*Bank Algeria for the Year 2008*, Master's Thesis in Economic Sciences, Specialization in Finance and Banking, Ammar Thliji University, Laghouat, 2012–2013, p. 73.

<sup>22</sup> Hussein Jawad Kazem and Munther Jabbar Dagher, *The Banking Sector in Iraq and the Constraints on Adapting to International Banking Supervision Standards – Basel II*, p. 168.

the Central Bank of Iraq organized a workshop to review and amend Law No. (56) of 2004, as well as Law No. (24) of 2004.

As part of the Central Bank of Iraq's efforts to enhance financial inclusion, total deposits within the banking sector increased from IQD 76.9 trillion in 2018 to IQD 82 trillion in 2019, achieving a growth rate of 6.6%. This reflects the continued relative improvement in economic conditions during 2019 <sup>[23]</sup>.

This increase is attributed to the growth in cash credit, which reached IQD 42 trillion in 2019 compared to IQD 38.5 trillion in 2018, achieving a growth rate of 9%. This was reflected in its increased relative importance within total credit, as its share rose from 60.30% in 2018 to 62.46% in 2019. Cash credit granted to the central government and the private sector recorded growth rates of 17.7% and 4%, respectively, while credit extended to public institutions declined by 0.8% during the same year <sup>[24]</sup>.

Credit extended by banking institutions to both the public and private sectors whether in the form of cash credit or contingent credit—recorded notable growth during the period under <sup>[25]</sup> study. In particular <sup>[26]</sup>, contingent credit grew by 5.5% in 2019, reaching IQD 67.3 trillion compared to IQD 63.8 trillion in 2018.

This increase is primarily attributed to the growth in cash credit, which rose to IQD 42 trillion in 2019 from IQD 38.5 trillion in 2018, representing a growth rate of 9%. This led to an increase in its relative importance within total credit, with its share rising from 60.30% in 2018 to 62.46% in 2019. Cash credit extended to the central government, public institutions, and the private sector recorded growth rates of 17.7% and 4%, respectively, while the growth rate of cash credit granted to public institutions declined by 0.8% during 2019.

With regard to contingent credit, it recorded a slight decline from IQD 25.33 trillion in 2018 to IQD 25.26 trillion in 2019, registering a negative growth rate of 0.26%. This led to a decrease in its relative importance within total credit, declining from 39.7% in 2018 to 37.5% in 2019.

Contingent credit extended to both the central government and the private sector recorded declines in growth rates of 3.32% and 0.38%, respectively, while contingent credit granted to public institutions witnessed a slight increase of 0.94%. This was accompanied by an increase in cash credit from IQD 38.5 trillion in 2018 to IQD 42 trillion in 2019, representing a growth rate of 9%, whereas contingent credit declined from IQD 25.33 trillion in 2018 to IQD 25.26 trillion in 2019, reflecting a decrease of 0.26%, which resulted in a reduction in its relative importance within total credit from 39.7% in 2018 to 37.5% in 2019.

The volume of overdue debts also declined compared to 2018, decreasing from IQD 4.8 trillion in 2018 to IQD 4.1 trillion in 2019, representing a decline rate of 15%. This reflects an improvement in loan repayment rates. Furthermore, the ratio of total overdue debts to total cash credit decreased from 12.8% in 2018 to 9.89% in 2019, as a

result of the reduction in non-performing loans within government banks. This indicates a decline in the level of risks faced by the banking sector, particularly those associated with the private sector, whose non-performing loans constitute the largest share of total defaults <sup>[27]</sup>.

Based on the foregoing indicators, the extent to which developments in monetary policy pursuant to the measures adopted by the Central Bank of Iraq and applied to the banking sector have contributed to enhancing its activity and development becomes evident. This is reflected, on the one hand, in the growth of bank capital and banking assets, and on the other hand, in the development of deposits and banking credit.

Credit determinants have previously been defined as: "a set of controls and conditions established by the authorities regulating economic activity with the aim of organizing credit operations. In the banking sector, these controls are determined by the monetary authority in light of the importance of credit and its role in economic activity, as well as its impact on achieving economic objectives, whether in terms of protecting depositors' funds, maintaining currency stability, or controlling the general price level. Commercial banks, in their capacity as credit-granting institutions, may also establish such determinants with the aim of mitigating credit risk, ensuring the recovery of their debts, maximizing shareholders' equity, and maintaining adequate levels of liquidity."

In light of the fundamental characteristics of the banking sector in Iraq—particularly with regard to credit facilities, which constitute the subject of this study—it becomes evident that there is a noticeable imbalance in the volume of lending activity. This imbalance can be illustrated as follows:

- The banking sector in Iraq relies heavily on the granting of loans against tangible collateral, which has resulted in the exclusion of approximately 95% of the population from access to credit. This constitutes a fundamental obstacle to the development of the private sector.
- By the end of 2001, the volume of loans extended by private banks to the private sector amounted to approximately USD 4 million, representing more than half of the total loans provided by the government banking sector.

In light of the economic and financial changes surrounding the banking sector, as well as the conditions prevailing in monetary and financial markets, monetary authorities and banking institutions resort to adjusting these determinants—whether by introducing new controls, modifying existing ones, or abolishing certain measures. Accordingly, these determinants are inherently dynamic and evolve in response to changing surrounding conditions.

The Iraqi legislator, within the framework of the Banking Law No. (94) of 2004, has incorporated a number of these determinants with the aim of achieving several objectives, which can be summarized as follows:

- Enabling the monetary authority to direct credit activity

<sup>23</sup> Central Bank of Iraq, Monetary and Financial Stability Department, Financial Stability Report 2019, p. 4.

<sup>24</sup> Central Bank of Iraq, Monetary and Financial Stability Department, Financial Stability Report 2019, p. 11.

<sup>25</sup> It includes all outstanding balances of all types of cash credit facilities and direct financing operations—such as overdrafts, discounted commercial papers, advances and loans, and any other credit facilities—provided by commercial banks to all economic sectors.

Central Bank of Iraq, General Directorate of Statistics and Research, Annual Statistical Bulletin, p. 7.

<sup>26</sup> It includes all outstanding balances of all types of contingent credit facilities—such as letters of credit and letters of guarantee—provided by commercial banks to all economic sectors. Central Bank of Iraq, General Directorate of Statistics and Research, Annual Statistical Bulletin, p. 7.

<sup>27</sup> Central Bank of Iraq, Monetary and Financial Stability Department, Financial Stability Report 2019, p. 4 et seq.

in a manner consistent with its economic objectives.

- Enhancing banking soundness requirements within banking institutions, thereby contributing to the achievement of financial stability.
- Strengthening confidence in banking performance and reducing investment risks, in a way that promotes the attraction of investments.

#### Types of Credit Determinants:

Credit determinants are often formulated in the form of ratios linked to the bank's sources of funds (liabilities) or to the uses of these funds (assets). The most prominent credit determinants commonly imposed by central banks include the following:

- The ratio of required reserves (cash reserves) to deposit liabilities held by banks.
- The ratio of statutory liquidity to total deposit liabilities.
- The ratio of total credit facilities to total deposit liabilities.
- The ratio of credit facilities granted to a single borrower to shareholders' equity (capital and reserves).
- Linking the value of credit facilities to the type and value of the collateral provided.
- Linking the type of credit facilities to total credit extended or to total assets.

In order to achieve these determinants, Article (30) of the Iraqi Banking Law, concerning large credit exposures, provides that:

No banking institution may grant credit to a person if doing so would result in:

The total outstanding principal amount of all credit facilities granted to that person exceeding 15%, or any lower percentage specified by the Central Bank of Iraq pursuant to its regulations, of the bank's capital and sound reserves, without obtaining prior approval from the Central Bank of Iraq, where such exposure is classified as a large credit exposure; or

The total outstanding principal amount of all credit facilities granted to that person exceeding 25%, or any lower percentage specified by the Central Bank of Iraq pursuant to its regulations, of the bank's capital and sound reserves.

The total outstanding principal amounts of all large credit exposures of the bank—pursuant to subparagraphs (a) and exceeding 400%, or any lower percentage specified by the Central Bank of Iraq pursuant to its regulations, of the bank's sound capital and sound reserves.

The restrictions set forth in paragraph (1) shall not apply to any principal amount of credit that is fully secured by collateral possessing a high degree of marketability, in accordance with the standards established by the Central Bank of Iraq for this purpose. However, no bank may grant such secured credit if doing so would result in the total

outstanding amounts of all secured credit facilities granted to the same person exceeding 20% of the bank's sound capital and sound reserves, or any lower percentage specified by the Central Bank of Iraq pursuant to its regulations.

The ratio of cash collateral required for letters of credit and letters of guarantee.

- Setting maximum limits on financing granted to a single borrower and related parties, including relatives, in order to reduce the concentration of credit risk.
- Identifying prohibited sectors or activities for the use of funds, as well as categories of persons who are restricted from obtaining loans and credit facilities—such as members of the board of directors and others—with the aim of minimizing conflicts of interest and enhancing banking governance.

In order to achieve these determinants, Article (31) of the Iraqi Banking Law, concerning transactions with related parties and senior <sup>[28]</sup> bank employees <sup>[29]</sup>, provides as follows: No banking institution may grant credit to any related party or to any senior bank employee:

If the approval of the Board of Directors—in the case of a local bank—has not been obtained for the granting of credit and the associated financial terms and conditions.

If the credit is granted to a bank officer or to a senior employee, and it results in the total credit facilities granted to that person and outstanding—including credit extended to one or more of their affiliated companies—exceeding 50% of their annual remuneration; or if it results in the total credit facilities granted to all related parties and outstanding exceeding 10% of the bank's sound capital and sound reserves, or any lower percentage specified by the Central Bank of Iraq pursuant to its regulations. These limits shall not apply to credit secured by a real estate mortgage granted to a local resident, provided that the appraised value of the property—according to the Central Bank of Iraq's valuation at the time the credit is granted—exceeds the principal amount of the credit by no less than one-third of that amount, or If the credit is granted on terms and conditions that are less favorable to the bank than those applied to the general clientele in accordance with prevailing banking practices in credit granting.

If the credit is not fully secured by adequate collateral, in accordance with the controls and standards prescribed by the regulations and instructions issued by the Central Bank.

A bank shall not purchase assets from, or sell assets to, any related party—whether a natural person, a bank employee or officer, or any affiliated party—in order to avoid conflicts of interest and ensure the integrity of banking transactions.

A bank shall not purchase assets from a related legal entity in the following cases:

If the approval of the Board of Directors—in the case of a local bank—has not been obtained with respect to the financial terms and conditions of the asset purchase

<sup>28</sup>This includes: any director of the bank; any person related to the director by kinship up to the second degree or by affinity, including adopted or foster children of the director, as well as any person residing in the director's household; any person holding a qualifying interest in the bank, or in an enterprise in which such person or a director of the bank holds a qualifying interest, and any director of such person or enterprise; any enterprise not consolidated in the bank's financial statements in which the bank holds a qualifying interest, and any director of such enterprise; in addition to the spouses and children of related persons within the first and second degrees, as well as the spouses and children of such persons.

<sup>29</sup> This includes any individual (other than an administrative employee), regardless of title, who performs the functions of one or more of the following positions within a local bank—or, in the case of a foreign bank, within its branch in Iraq: Chairman of the Board, General Manager, President, Chief Executive Officer, Chief Operations Officer, Chief Financial Officer, Head of Lending, or Head of Investment. The term "senior bank employee" also includes any other person designated by the Central Bank of Iraq to comply with the requirements set forth in paragraph (4) of Article (18) of this Law, in addition to any person related to such a senior bank employee within the first or second degree, as well as the spouses and children of such persons.

transaction.

If the assets are purchased under terms and conditions less favorable to the bank than those applied to the general clientele in accordance with prevailing banking practices in such transactions.

The bank's Audit Committee (Internal Audit) must be immediately notified of any instance of granting credit to, or purchasing assets from, a related party or a senior bank employee, in the case of a local bank. If the bank grants credit or purchases assets from a related party in violation of the provisions of paragraph (1), such credit must be settled immediately. Members of the Board of Directors or authorized managers, as the case may be, shall be held jointly and personally liable for the repayment of the principal amount of the improperly granted credit, if such action was taken with their knowledge and without objection, in addition to bearing any interest and other charges arising from such credit.

The Central Bank of Iraq may issue instructions requiring the bank to deduct any loan granted to a related party or to a senior bank employee from its capital, for the purposes of calculating the ratios in accordance with the provisions of paragraph (1) of Article (16).

Furthermore, banking institutions may impose additional determinants that are periodically adjusted in response to changing conditions. Among the most prominent of these determinants are:

- Linking the granting of long-term loans to the level of stable deposits held by the bank.
- Aligning the growth rate of credit with the growth rate of deposits.
- Defining credit approval authorities for each administrative level within the bank.
- Excluding certain sources of funds—such as government and seasonal deposits—from the pool of funds available for allocation.
- Determining the allocation ratios for each type of credit in light of available funding sources.
- Establishing maximum limits for each type of credit, along with specifying their purposes and the conditions governing their granting.
- Setting upper limits on external indebtedness, and defining the required collateral against such exposures, in order to reduce the concentration of risk in this category of investments.

## Conclusion

### Findings and Recommendations

Despite the legislative efforts undertaken to advance the Iraqi banking sector, its performance continues to exhibit evident weaknesses, which have negatively affected its role in supporting development and investment. This is evident through the following <sup>[30]</sup>:

The decision of the Central Bank to permit the granting of cash credit equivalent to eight times the bank's capital—without considering the volume of deposits held by private banks—has led to an increase in interest rates on credit, thereby constraining the provision of such facilities.

The weakness of borrowers' creditworthiness, as they are

predominantly characterized by moral hazard-related risks.

The difficulty in assessing adequate and appropriate collateral for the granting of credit, due to the impact of inflationary expectations and the associated market risks.

The limited financial soundness of most banks, particularly private banks, which restricts their ability to expand credit activity, especially in light of a deposit structure predominantly characterized by short-term deposits.

The low level of banking density, which negatively affects the efficiency of credit operations, particularly given the concentration of most banks in the capital.

There is a lack of administrative structure in a number of banks, especially government banks.

### Recommendations <sup>[31]</sup>

Despite the significant challenges facing the Iraqi economy in general, and the banking sector in particular, and despite the continuous efforts made to develop this sector, especially after 2003 with the issuance of the Central Bank of Iraq Law No. (56) of 2004 and the Banks Law No. (94) of 2004, the advancement of the banking sector still requires concerted efforts and strengthening protection mechanisms, especially with regard to credit facilities and granting loans.

This is attributable to the fact that banking performance indicators in Iraq have not yet reflected a clear model consistent with the commonly accepted ratios between capital, deposits, and credit. The ratio of cash credit to deposits in government banks reached 53% in 2015, while the ratio of cash credit to owned capital—including reserves—stood at 76%. Although this ratio is considered acceptable on average, it exhibits significant variation, rising substantially in Rafidain Bank and Rasheed Bank beyond commonly accepted limits.

In private banks, the ratio of cash credit to deposits reached 84%, which is generally considered an acceptable level. However, this ratio exceeded the volume of deposits in 18 private banks, indicating that a portion of credit is financed from capital. Meanwhile, the ratio of cash credit to capital in private banks stood at approximately 93%, reflecting a weakness in the efficient utilization of capital at the sectoral level. This suggests that the total banking capital significantly exceeds market needs, largely as a result of the increasing number of banks. Total deposits amounted to approximately IQD 62.4 trillion in 2016, a level that is less than one-third of the gross domestic product. Moreover, a substantial proportion of these deposits consisted of current deposits that do not bear interest, indicating relatively low funding costs.

On the other hand, the volume of private deposits amounted to approximately IQD 23.7 trillion, which remains relatively limited compared to the size of the private sector's contribution to gross domestic product. Private banks attracted around IQD 8,592 billion of these deposits, of which current deposits accounted for 73.6%. This indicates that the issue does not lie in high funding costs, but rather in the limited volume of deposits flowing into these banks. This issue becomes more pronounced when compared to capital, including reserves, which reached approximately IQD 9,902 billion in 2016—excluding government banks. This implies that the average deposits per private bank are roughly equivalent to their capital, a phenomenon that is uncommon

<sup>30</sup> Muntadhar Fadhil Saad, "Challenges Facing the Iraqi Banking Sector," *Journal of Financial, Accounting and Administrative Studies*, Issue 5, June 2015, p. 29.

<sup>31</sup> It is noteworthy that some of these recommendations were proposed by the Finance Committee of the Iraqi Council of Representatives. Iraqi Council of Representatives, Finance Committee, 2015, pp. 44–47.

in the banking sector.

Given that deposits represent the primary source of credit financing and the main component of bank assets, the ratio of these assets to capital is remarkably low and does not meet even the minimum standards of banking efficiency. This problem is likely to worsen if new banks enter the market. This reflects the inability of the private banking sector to build sufficient internal capacity to fulfill its role in granting bank credit, as well as the limited capacity of the credit market to absorb the volume of bank capital. Therefore, the researcher recommends the following:

1. The need to reassess and update banking legislation in a way that contributes to the development of the Iraqi banking sector to keep pace with global developments and enhances its ability to face challenges, especially in the field of credit facilities.
2. The focus is on expanding the scope of credit and financing and providing affordable loans, while working to activate the employment of deposits more efficiently.
3. Organizing specialized workshops and conferences aimed at analyzing the efficiency of bank performance and ways to develop their credit departments.
4. Developing integrated strategies to improve credit standards in a way that contributes to attracting and encouraging foreign investment and promoting economic development.
5. Developing human capital in banking institutions by developing the skills of employees and raising their efficiency to keep pace with rapid technological developments.
6. Developing human capital in banking institutions by developing the skills of employees and raising their efficiency to keep pace with rapid technological developments.
7. Expanding the opening of new banks and branches of existing banks in major cities outside the capital, which contributes to increasing banking density.
8. Preparing studies and research supported by accurate data and statistics on the credit market in Iraq, with the aim of diagnosing credit gaps and developing practical solutions to address them.

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## How to Cite This Article

Kazem HJ. The Iraqi legislations regulating the granting of credit facilities. *Int J Multidiscip Res Growth Eval*. 2026 Mar-Apr;7(2):568–579.  
doi:10.54660/IJMRGE.2026.7.2.568-579

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