Empirical Investigation Of Implementation Of Credit Risk Management Among Iraqi Banks

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Abstract

In order to properly manage risks, an institution must recognize and understand risks that may arise from both existing and new business initiatives; for example, risks inherent in lending activity include credit, liquidity, interest rate and operational risks. Risk identification should be a continuing process, and should be understood at both the transaction and portfolio levels.

Credit risk is the likelihood that a debtor or financial instrument issuer is unwilling or unable to pay interest or repay the principal according to the terms specified in a credit agreement resulting in economic loss to the banking institution.

Credit risk means that payments may be delayed or ultimately not paid at all, which can in turn cause cash flow problems and affect its liquidity. Credit risk is still the major single cause of bank failures.

Credit concentrations, are viewed as any exposure where the potential losses are large relative to the banking institution's capital, its total assets or, where adequate measures exist, the bank's overall risk level. This may be in the form of single borrowers or counterparties, a group of connected counterparties, and sectors or industries, such as trade, agriculture, etc or in the form of common or correlated factors. The Asian crisis demonstrated how close linkages among emerging markets under stress situations and correlation between market and credit risks as well as between those risks and liquidity risk, can produce widespread losses.

The credit process issues, many credit problems reveal basic weaknesses in the credit granting and monitoring processes. While shortcomings in underwriting and management of credit exposures represent important sources of losses at banking institutions, many credit problems would have been avoided or mitigated by a strong internal credit process. The paper reviews existing literature that consists mostly evidence from developed countries. A study model is proposed with amendment to fit Iraqi environment.

Keywords –Investigating Credit risk management system, Iraqi Banks

Introduction

The credit risk philosophy is a statement of principles and objectives that outlines the institution's willingness to assume credit risk and will vary with the nature and complexity of its business, the extent of other risks assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

A financial institution plays critical roles in developed economy. The granting of credit is the main function and important by the commercial banks to achieve their goal (Shahien, 2009). Credit represents most of the assets of banks and contributes the largest share of its operating income (Abokhozana.2007). The practices of any activity is always accompanied risk and the likelihood of success and failure, so the risk of default remains always list which falls on bank depositors thus, banks loans employ in safe way from the expected risk. It is noted that as a result of the economic conditions experienced by Iraq, the consequent creation of an almost complete paralysis in all aspects of economic. There is indications that weakly functioning banks hinder economic progress and aggravation poverty, while well-functioning banks accelerate develop economic growth (Barth et al., 2000). The problems of credit risk comes from non-Repayment the commitment to the banks, due to of the general environment in which the projects operate. The gravity of the level of loss caused by credit risk compared with the services provides cause bank failures (Chijoriga, 1997).

Day by day, there have been a growing number of significant bank problems in both matured and emerging economies due to new services provided such as electronic banking led to appear different type of risk. Many researchers have studied the underlying causes behind bank problems and identified several factors (Chijoriga, 1997; Santomero, 1997; BrownBridge and Harvey, 1998; Kimei, 1998; Basel, 1999, Basel, 2004). The underlying cases Credit problems, is a lack and weakness in credit risk management, it is determined to be integral part of the major reasons behind banking difficulties. Granting loans form a large part of credit risk as they normally account for 5-15 times the property rights of a bank (Kitua, 1996). So many of the projects that got the credit became unable to repay to banks (Policy Research Department, Monetary Authority, 2008). Thus, bad quality of loans in banking business is likely to face difficulties led to a slight deterioration. Information processing mechanism of loan quality has its roots any lack of information led to deterioration of the process of granting credit. (David Babble, 1998)Shows that these problems in developing countries are at their highest level. The first problem starts with the loan application stage (Liuksila, 1996) and then maximize at the loan acceptance, monitoring and controlling stages, especially when credit risk management elements in terms of framework in credit risk actions for credit processing do not exist or weak or incomplete or not applicable.

Lending has been, and still is, form an integral part of the banking business, and this is true in the emerging economies like Iraq where capital markets are not yet and still not well developed. It has been mentioned out that in order to minimize loan losses and so as the CR, it is necessary for banks to have an effective CRM system in place (Santomero, 1997; Basel, 1999). Given the non-identical and incorrect information that exists between lenders and borrowers, banks must have a mechanism to ensure that they not only evaluate default risk that is unknown to them in advance in order to avoid negative selection, but also that can develops later in order to avoid moral risks. This study focuses on understanding the credit risk management system of a banks operating in Iraq, and suggested a research model for further studies. The paper is includes: previous studies in credit risk management. Then problem statement and methodology. Then discusses the results of the study. Last the conclusions.

Previous Studies

Non-performing loans liquid are found in the portfolios of most banks and constitute a high and large percentage of assets in banks is caused highest credit risk (Koch and MacDonald, 2000).

(Auronen, 2003), The information is located and incorrect information led to be impossible to knows which good borrowers or which bad borrowers, which may give result in bad choice

and moral risks problems.

Abu-Kazana , 2007)This study aimed to propose a model for measuring credit risk in banks and development of accounting disclosure , the most important findings of the study inadequate disclosure of the credit risk in banks and allocations, and his palaces to provide a clear picture of them as well as the failure to indicate the size of these risks and their impact on the bank's assets and determining the size of allocations due to meet them. The study recommended the necessity of activating the proposed model for measuring credit risk and relied upon in determining the allocations to be more realistic and objective so as to provide a clear vision for the users of financial statements in banks.

Al-Dekem, 2006) The aimed of this study to analyze the foundations of the credit standards in banking, and basic elements, and the importance of follow-up credit to verify the continuity of the safety of putting the customer's ability to pay the premiums due from it for the prevention of the dangers of bad debts and protect the rights of the bank. study found several of the most important results of the bank's failure is unable conduct careful analysis of the risks that accompany the granting of lending operations and calculating the cost of accuracy where focus on physical collateral from its dependence on the source of repayment as collateral for the credit. One of the main recommendations of this study is needs to develop a strategy through monitor the credit portfolio and follow-up , and the application of appropriate analytical model from which to studying the case of the client and monitoring failures in order to avoid or reduce the risk . The process of credit risk management in banking industry is identification, measurement, assessment, monitoring and control. It involves identification of potential risk factors that have greatest influence in banks, estimate their effects, monitor activities exposed to the specific risk factors and put in place control measures to avoid or reduce the undesirable effects. This process is applied within the operational framework of the bank. (Heffernan, 1996; Kealhofer, 2003).have been proposed risk-adjusted performance measures.

(Nasser , Arshadi, 1991) To determine the effect of the change in the policies and pricing strategies for customers in U.S. banks, and to achieve this goal have been prepared questionnaires and distribute them to the vocabulary of community study, which was divided into three types namely banks offer their services Traditionally, banks available to their technological development, and banks rely on professional development It seeks to reduce the cost of their products. The study found that the banks rely on providing services by traditional methods largely unable to pricing of these services by competitive pricing in the market, which prompts to provide the services at prices equal to the costs.

Effective credit risk management need building an audible credit risk environment; operating to improve credit granting process; maintaining an appropriate credit administration that includes monitoring and controls over credit risk (Basel, 1999; Greuning and Bratanovic, 2003; IAIS, 2003).credit risk management requires proper and clear framework and guidelines in managing credit risk, i.e. all guidelines are properly and directly communicated throughout the organization; to make everybody can contributes in credit risk management and understand them.

(Prasad and Harker, 2000) Identify the impact of pricing policies for the services of modern banking provided these services, and their relationship to reduce costs compared to the costs of conventional similar, were to make a comparison between traditional services and modern services and the extent of the contribution of each in reducing the costs of running money through a questionnaire was distributed to the population of the study represented in a number of U.S. banks and a group of banks customers. One of the most important results of this study that the banks provide services at affordable prices has a significant impact on the extent to attract customers to deal with, and that banks maintain the standards of minutes to work on the pricing of their services to attract more clients and motivation for these services **.**

Furthermore, monitoring process of borrowers is very sensitive stage as current and potential exposures. Change with both the passage of time (Donaldson, 1994; Mwisho, 2001), and also very critical and important in dealing with ethical risk problem (Derban et al., 2005). Monitoring credit requires, among many things, direct communicate with borrowers, to deal with the situation and improve the culture of being supportive to borrowers however they are striving to recognized the difficulties ; a solver of problems and trusted consulted should be creating an environment; through the bank’s account; to flow of borrower’s business can monitoring and review history and reports as well as an on-site visit, modernization borrowers credit files, and borrowers rating assigned at the time of the credit was granted (Donaldson, 1994; Treacy and Carey, 1998; Tummala and Burchett, 1999; Basel, 1999; Mwisho, 2001). Tools like guarantees, collateral, using derivatives, ranking customers, credit rationing, loan securitization and loan in controlling credit losses (Benveniste and Berger, 1987; Greenbaum and Thakor, 1987; Berger and Udell, 1992; Hugh, 2001). The depth of knowledge increased and judgment needed is always available are very important to ensure that the high-quality credit risk management staffs are required thus successfully managing the credit risk in the banks (Koford and Tschoegl, 1997; Wyman, 1999).

Demirguc-Kunt and Huzinga (1999) Credit risk management is divided in two part which includes, the investigation the risk that after losses have occurred, the losses becomes difficult and cannot developments in the field of financing commercial paper, liquidity, securitization, and other competition which pushed banks to find viable loan borrowers. The main source of credit risk include. The main source of credit risk relating to the risk of the borrower, risks of private activity Risks related to the process of granting creditو limited institutional capacity, inappropriate credit policies, volatile interest rates, poor management, inappropriate laws, low capital and liquidity levels, direct lending, massive licensing of banks, poor loan underwriting, laxity in credit assessment, poor lending practices, government interference and inadequate supervision by the central bank (Kithinji, 2010).

Increasing in credit risk causes to liquidity and solvency problems. Credit risk may increases due to that if the bank lends to borrowers and it does not have adequate knowledge about grant credit.

Donaldson (1994) and Jeremy and Stein (1999) shows that using technology are benefit in credit analysis, monitoring and control, which make track on trend of credit risk within portfolio easy and benefit. Marphatia and Tiwari (2004) said to make all activities easy and useful and help how they think and how they interact with one another so that risk management is primarily about people. Using technology in the wrong hands it is useless technology is just tools help to make things more benefit.

Problem Statement

Credit risk has caused loan losses problem in developing countries, including Iraq. The problem has its roots in information problems that particularly cause adverse selection and moral risks. Effective credit risk management system minimizes the credit risk, help to decrees the level of loan losses. There is numerous studies on the management of credit risk in banks. The main problem of management of credit risk in the banks has its roots is a lack of information that particularly cause different of selection and ethical risks. Many empirical studies show differences in practices of credit risk management in different contexts and in different countries (Menkhoff et al., 2006; Mlabwa, 2004) this study is attempts required to an understanding of the credit risk management phenomena of credit risk management in Iraqi context. To understanding the credit risk management as a phenomenon is a process which required rich and full data and information in its context to be collected. This situation required the integration of an inductive approach (Haider and Birley, 1999). The **case study approach** needed a suitable strategy in collecting empirical data. The nature of the study required an understanding of the CRM phenomena within an Iraqi context. Then the information required was qualitative approach and contextual and was analyzed qualitatively. It need was an appropriate strategy in collecting the required empirical data. Thus, collecting information required was qualitative and contextual and then was analyzed qualitatively. The reasons of why choosing of the case is that it has need to be rich information that help to granting credit to brewers (Patton, 1990; Huberman and Miles, 1998; Yin, 2003). The bank that was had active in lending activities, had its operations, and was ready to tack advantage of necessary information provided the best case for the study (Morse, 1994; Tellis, 1997; Johnson and Christensen, 2004). Credit risk policy and manual for the bank were directly read and analyzed. In credit management department top manager official were interviewed for the purpose of to explain the credit risk strategy, policy and documentation. in order to ensuring data in to force (Valentine,1998), and to got other information that not appeared in the document and need to explain to the researcher.

Objective of the Study

This paper adopted literature reviews that include evidence in Iraq. A study model it is suggested model to be suitable in Iraqi banks climate. Understanding credit risk management conceptually. Studying the banks practicing credit risk management. Understanding the importance of the credit risk management and how useful it is to the banks and how it benefits them in various ways the selected of Iraqi is due to banks actives in lending short term and middle term, in local loans in its operations and has been in operation for a longer period. Iraq ranks among the developing countries economy, of the factors that shape an excellent case for studying how banks working in environment with less sophisticated financial to manage their credit risk. The paper open path for further research in order to building credit risk management system by banks operating in Iraq.

Research Question

Are banks in Iraq Implements of Credit risk management?

Sample Method

The Sampling Method was used to collect the data about the current practices followed by the commercial banks in Iraq as far as credit risk management goes. Only commercial Banks have been taken because the purpose of this study was to understand the in-depth knowledge on Banks practicing Credit risk management.

Data Collecting

The data collection i.e. the raw material input for the project has been collected keeping in mind the objectives of the project and accordingly relevant information has been found. The methodology used is a descriptive method of the Research. Following are the sources:

Primary Data

The data regarding "CREDIT RISK MANAGEMENT" was collected through primary data: interviews with managers department information from a banks and senior managers which dealing with credit management and works in credit risk management department in Iraqi banks

(See Appendix A).

Chief Manager of credit risk in Al-Rashid bank.. This was done to understand the current practices and the style of functioning of the credit risk management departments of this bank.

Secondary Data

The data had been collected by reading various books deferent relevant documents, guidelines, reports on Credit Risk Management, Articles, Internet, document, guidelines of bank, (refer Bibliography). Also some part of the data was collected by Bank Booklets and letters issues from the Central Bank.

Findings and Discussion

The bank has a well-documented CRM policy that elaborates the products offered and all activities that have to be performed to manage the CR. It has also a credit manual that documents and elaborates the strategies for managing CR and they are formulated in compliance with the bank credit policy. Strategies for granting credits **focus on who, how and what** should be done at the branch and corporate division levels while assessing borrowers. Also, **who, how and what** should be done at the head office while approving the credits. The implementation of credit risk management required capital (Affect capital in the lending policy by having a legal relationship between the amounts of capital on the one hand and the volume of credit granted on the other hand, the capital is considered a backstop to prevent the leakage losses of deposits).

Probability(Bank institutions aimed to make a profit, so the lending policy of the bank based on profit-making through the adoption of flexible lending policy or strict accordance with the margin of risk that can be borne by the bank).

Financial position of the borrower (Banks rely on a range of influences that reflect the financial solvency of the client and its ability to meet its obligations).

The national economy needs (Credit policy is subject to the needs of the community of credit and are therefore affected by the level of economic activity, and often resort to diversification in loans to meet the needs of different economic credit to increase the volume of investments and contribute to economic development) , deposits stability(the stability of the deposits have a direct impact on the credit policy, the larger the deposit enjoyed relative stability, the bank's ability to extend credit increases, giving it the right opportunity to extend credit much more diverse and larger.

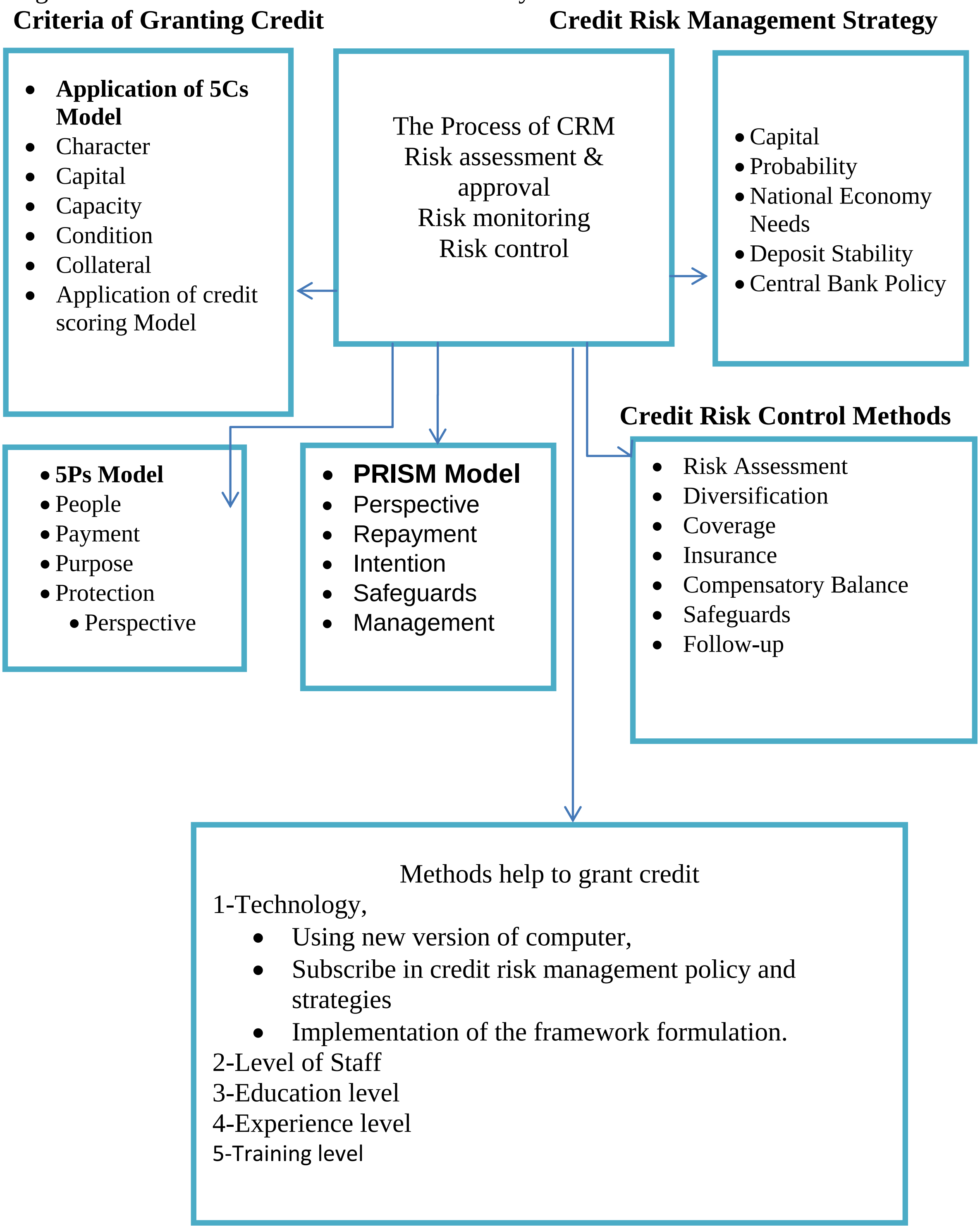
Central bank policy (Puts the central bank is usually a set of controls for banks to adjust credit operations in accordance with the requirements of the economic situation prevailing in the country with regard to the size of the lending and its quality and its limits, which are connected all counting the economic situation and the level and size of the money supply and directions of the monetary policy of the central bank).

The policy of grant credit risk required well-documented. Most of the bank has a well-documented in credit risk management, services offered and all activities was required and have to be performed to manage the credit risk. Banks It has also a credit guideline, manual for managing credit risk and they are formation of this element in line with the bank credit policy. Strategies for granting credits depends on profitability , liquidity and safety and also focus on how to granting to whom granting and what should be done at the branch and main office levels while assessing borrower while evaluating borrowers. Also, who, how and what should be done at the senior management office while endorsement and approving to grant credits to the borrowers. Numerous checklists are needs to assessing borrowers and establishing their ability and credit worthiness. This study found banks not used quantitative credit scoring models due to a lack of information regarding borrowers .The operation depends on personal experience, intuition and anticipation plays an important role in credit assessment. Using The (the five Cs) borrowers capacity character, condition, credit history and collateral are adopted all time (Al-Kateeb, 2004) it was used to observed and follow the poor bookkeeping and lack of effective database and information systems in many sectors was not able to use credit -scoring model due to a lack of experience and effective database and information’s regarding to customers. However, the process of credit granting, is morality, knowledge and science. Must use in banks to avoid risks. Not to use a form which includes the (5Ps) people, purpose, protection, perspective (Al-Zubedy, 2002).Also not use PRRISM model which includes perspective, repayment, intention or purpose, safe guards, management to avoided credit risk (Al-Zubedy, 2002).

The senior manager communicates with other branches to inform them that the credit has been acceptable and confirmed. So the power of approval, depends on is used and distributed to different personnel within the credit management structure this is a private property, at that time the manager in the branch of bank can benefit of the credit when all the requirements have been achievement of all. The credit officer who responsible for the customer is the one who is dealing and keep track with the customer all time on a day-to-day and follow him to be sure that credit use at same purpose of the grant , and is in a good position to know whether need extra money or not. Borrowers ‘competent activities, their performance, as well as behavior monitored , by both branches and main office cooperating on daily to determine whether there are any changes that need to be taken to protect non-repayment of credits.

Credit risk management depends on involves of all staff members who works in credit risk department to provide all information required to grant credit to the customers. . The shared information has been get suggestions from branches. This common practice consolidation the bank credit risk system as the implementers not only takes ownership of what they are implementing (Price Water house, 1994), but also understand the policies and strategies, as they are the same people who getting started them (Santomero, 1997; Basel, 1999) . In banks management of corporate credits is assigned to experienced staff with high experience in credit risk granting. New employees are required and need more training and exercises to hold responsibility .Differs trainings are conducted by the bank where staff members in the credit risk section are expected to attend. The bank also sends its staff to various trainings to improve and update their knowledge and skills in credit risk management. This means that the banks take care and increase the emphasis to puts in the quality of staff involved in credit risk management. Not being able to provided new version system that relevant information is fed into the system that produces various reports at the end of each month. These reports are used for making decisions on managing credit risk and check how well the strategy. Computers are used in performing some analysis and shortage time efforts while assessing and managing borrowers. Figure 1 show a summary of the credit risk management system of the banks in Iraq, to which is a refined research model to be studied further.

Figure 1.Refined research model for the CRM system of banks



Source: Empirical data

Conclusion

From the financial economics literature that the credit risk management in banks required good strategy and policy that help banks to provide general information to how grant credit and to how grant and what need to grant credit to customers.

Credit risk management needs high skill staff and technology. Environment that banks work in plays important rolls and have great influence in managing credit risk. The comprehensive framework need to implementation of credit risk management to avoid risks. The proposal model in tis article is an important contribution because of all literature is based on well-development word economies.

Recommendation

Based on finding the study b recommended

1-That banks in Iraq should enhance their capacity in credit analysis and loan administration while the regulatory authority should pay more attention to banks' compliance to relevant provisions of the Bank and other Financial Institutions and prudential guidelines and fallow all issues from Central Bank.

2-Improvement in risk management practices of the banking system. This implies an assessment of current business and risk management practices domestically and encouragement of best practice, particularly in terms of the risk implementation of framework.

3-Training and development of a new supervisory culture.

4-Upgrading of financial infrastructure.

5-Resort to creative solutions to address some of the aforementioned weaknesses, such as the incorporation of debtor data from nonfinancial institutions, partnerships with local academic institutions to launch risk management training courses, or the obligatory pooling of loss data and the use of public credit registers for calculating risk parameters in smaller or less advanced banking systems

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Appendix A:-

INTERVIEW

With regard to my study the questions asked to Credit Risk Manager

1-What is credit risk management?

2. Does the bank have a separate credit risk department? What are its functions?

3.How does the bank go about collecting information about its borrowers? Who does it?

4-Are there different Rules and Procedures for banks in grant credit?

5-Does the bank rate its borrowers?

6-What is the recovery procedure in case of a defaulter? What does the bank do when the borrower becomes bankrupt?

7-Is some insurance there for covering credit risk?

8-How does the bank go about credit risk portfolio management?