Financing Structure and Financial Flexibility: Evidence from the commercial Banking Sector in Iraq.

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Abstract

This study aims to examine the impact of capital structure on the financial flexibility of Iraqi commercial banks, through an analytical and econometric study of a sample of banks listed on the Iraq Stock Exchange during the period (2005–2023), a period marked by significant economic and security shifts, including the global financial crisis, the war against terrorism, and the COVID-19 pandemic. The study focused on two main variables: Financing structure—comprising equity and debt financing—and financial flexibility, representing the banks' ability to adapt to financial shocks.The findings revealed that most Iraqi banks rely heavily on short-term financing, which increases liquidity risk and undermines financial stability. In contrast, banks with higher equity ratios demonstrated greater capacity to absorb shocks. The econometric model confirmed a significant positive relationship between the equity-to-total-assets ratio and financial flexibility, emphasizing the importance of internal financing in enhancing resilience.The study recommends restructuring funding sources to reduce reliance on short-term debt and integrating financial flexibility as a regulatory

metric within performance evaluation frameworks.
Keywords: *Capital Structure, Financial Flexibility, Equity Financing, Debt Financing, Iraqi Commercial Banks.*

Introduction

The banking sector continues to face persistent challenges that necessitate enhancing banks' ability to adapt to economic and regulatory changes. One of the fundamental elements influencing performance efficiency is the capital structure, which determines the optimal mix between equity and debt financing. On the other hand contrast, the concept of financial flexibility has emerged as a critical tool for assessing a bank's ability to withstand crises and maintain financial stability.

The Iraqi environment during the period 2005–2023 experienced exceptional conditions, including financial, political, and security-related crises. These circumstances underscore the importance of examining the relationship between capital structure and financial flexibility. Therefore, this study aims to analyze the impact of capital structure on the financial flexibility on a sample of Iraqi commercial banks lusted the Iraq stock exchange through an analytical and econometric approach applied to a sample of banks. The study contributes to the academic understanding of this relationship and to provide practical recommendations that support the stability of the banking sector.

Section One: Research Methodology and Previous Studies

1. Study Objectives:

- To analyze the structure of capital financing in Iraqi commercial banks and determine the optimal mix between equity and debt financing.

- To assess the flexibility of the banking system in responding to unforeseen changes by relying on selected financial indicators.

- To examine the impact of capital structure—both equity and debt—on financial flexibility during the study period.

2. Significance of the Study:

- This study highlights a relatively new combination between capital structure and financial flexibility, a relationship that has received limited attention in previous literature.

- It contributes to narrowing the research gap regarding financial flexibility, especially within developing economies such as Iraq.

- The significance of the study also stems from the economic crises, such as the 2008 global financial crisis, which emphasized the need to reassess capital structures of financial institutions in order to enhance their stability and resilience.

3 Study Problem:

The central Study problem is expressed in the following question:

To what extent does the capital structure of banks affect their

financial flexibility in the context of the Iraqi economy?

From this main question, the study derives the following sub-hypotheses:

- There is no statistically significant impact of equity indicators on the financial flexibility of the banks in the study sample.
- There is no statistically significant impact of debt indicators on the financial flexibility of the banks in the study sample.

4. Study Tools:

The study adopted a descriptive-analytical approach to examine the relationship between the variables of capital structure and financial flexibility, using panel data for a sample of Iraqi commercial banks listed on the Iraq Stock Exchange for the period from 2005 to 2023. The EViews statistical program was used to estimate the econometric models and test the hypotheses. The data sources consisted of the annual reports issued by the banks, the statistical bulletins of the Central Bank of Iraq, and the Iraq Stock Exchange.

The analysis of the study variables will be conducted based on the indicators of capital structure and financial flexibility, including:

• The ratio of total debt to total assets
• The ratio of total debt to equity
• The ratio of equity to total assets
• The capital adequacy ratio
• The cash balance ratio

5. Previous Studies:

Several studies have addressed the relationship between capital structure and financial flexibility from different

perspectives. Al-Husseini (2021) examined the possibility of utilizing capital structure to reduce financial fragility, and found that increased reliance on debt exacerbates financial instability. In a similar context, Khudair (2023) concluded that depending on short-term financing leads to a decline in profitability, which highlights the importance of maintaining a balanced capital structure. On the other hand, Al-Taie and Al-Jubouri (2017) approached financial flexibility as an independent variable and confirmed that highly flexible banks demonstrated a greater ability to withstand shocks. In terms of financial performance, Al-Hoori (2022) showed a significant impact of financial flexibility on enhancing profitability indicators. This finding was also supported by Al-Attar (2023), who found that the absence of financial flexibility weakens the efficient use of assets and equity. Jabir (2023) focused on the role of flexibility in reducing financial distress and recommended adopting self-financing and secure debt as alternatives to expensive financing methods. From a methodological riew, some studies adopted advanced econometric models. For instance, Al-Aaridhi (2024) used the Panel Data model to measure the interactive effect of financial flexibility on financial stability. Meanwhile, Al-Askari and Al-Bakri (2023) employed the Altman model and proved that banks with high levels of flexibility and stability are more capable of avoiding financial distress.

As for previous studies, they were more diverse and advanced in their models for example. The study by Ferrando et al. (2014) confirmed that financial flexibility enables institutions to take advantage of investment opportunities even during times of crisis. Similarly, Pendar et al. (2018) demonstrated that flexibility is a key determinant in making capital structure decisions. In the same context, the study by Omara & Rashid

(2024) linked board experience, investment efficiency, and the role of financial flexibility, noting that increased experience may reduce efficiency when flexibility levels are high. The study by Han (2023) found an inverse relationship between flexibility and financial distress costs, emphasizing the importance of liquidity and cash reserves. Meanwhile, Wei et al. (2024) confirmed that flexibility reduces overinvestment and positively influences both market and accounting performance, especially when investment efficiency is achieved.

These studies reveal variations in their findings depending on the environment and indicators used. Some employed linear regression and panel data models, while others relied on traditional financial ratios. The importance of the current study lies in the fact that it is among the few that directly model the relationship between capital structure and financial flexibility within the Iraqi banking sector, thereby contributing to filling a clear research gap in this field.

Section Two: The main Concepts Related to the Study
First: Financial Structure

Financial structure refers to the mix of funding sources used by institutions to finance their investments. An institution can fund its investments through internal financing sources such as retained earnings, or through external sources such as loans or bonds (Aljamaan, 2018:50). Uninformed or poorly made capital structure decisions may lead to an increase in the cost of capital, thereby reducing the value of the institution. Conversely, well-planned and efficient financing decisions

can lower the cost of capital, which increases the firm's value and, consequently, enhances shareholders' wealth (Gitman & Zutter, 2015:575).

In commercial banks, the financial structure includes the following components:

1. Debt Financing

1.1 Long-Term Financing

Long-term financing is considered one of the main sources used by banks to finance large-scale projects with expected future returns. It includes instruments such as loans and bonds and takes into account interest rate risks and default risks (Farah, 2014:25).

Long-term financing sources are divided into several types, including:

1.1.1 Loans: Loans refer to the funds obtained by institutions to implement a specific project. These loans are acquired from banks at an agreed-upon interest rate and a predefined repayment schedule (Ibrahim, 2020:126).

Although the interest rate varies across banks depending on their strategies, size, and external environment, the ratio of loans to total deposits in the Iraqi banking sector ranges between 47% and 55%, according to the Central Bank of Iraq (2024, p. Official Data).

1.1.2 Bonds: A bond is defined as a financial debt instrument that is tradable, granting its holder the right to receive regular periodic payments at a fixed rate based on the nominal value stated in the bond certificate (Al-Nuaimi & Al-Tamimi, 2018:139).

1.2 Short-Term Financing: Short-term financing includes several types, as follows:

1.2.1 Commercial Credit: This is a short-term loan obtained by an institution from suppliers for the advance purchase of goods and services. It is particularly important for small

businesses, as they often rely on it as an alternative to high-cost loans. Commercial credit is commonly used when working capital is insufficient to meet current operational needs (Abdelraheem & Serajeldin, 2017:1290).

1.2.2 Bank Credit: These are short-term loans that do not exceed one year. They are used to address temporary mismatches between incoming and outgoing cash flows or to pay due taxes in the event of insufficient liquidity (Abdelraheem & Serajeldin, 2017:1290).

1.2.3 Commercial Papers: These are simple instruments used to settle commercial transactions between parties. Commercial papers play several economic roles and are widely used in business dealings (Abdulazim, 2020:35).

2. Deposit Financing:This type of financing takes several forms, including**:**

2.1 Current Deposits: Current deposits are a primary source of funds for commercial banks. They are characterized by the ability to be withdrawn immediately without prior notice, which increases banks' exposure to liquidity risks compared to other financial institutions (Hassan, 2019:195).

2.2 Savings Deposits: These are deposits placed by customers in exchange for interest, with the flexibility to withdraw at any time without notice. They are often used by individuals with moderate incomes due to the ease and flexibility of deposit and withdrawal processes (Haddawee & Flayyih, 2020:227).

2.3 Term Deposits: Term deposits are characterized by a fixed maturity period and a fixed interest rate. They offer banks an opportunity to manage funds more steadily, while providing depositors with a higher return compared to other types of deposits (Al-Musawi, 2022:22).

3. Equity Financing: This type of financing includes the

following:

3.1 Ordinary Shares: The bank's ownership rights are represented by each ordinary share held. Every share grants its holder an equal ownership stake, as well as the right to participate in the company's profits and receive dividend distributions (Gupta, 2022:66).

3.2 Preferred Shares: These are financial instruments that represent ownership rights with a higher priority claim over profits and assets compared to ordinary shares. Holders of preferred shares must receive fixed dividends before ordinary shareholders can receive any distributions (Melicher & Norton, 2017:268).

3.3 Retained Profits: Retained profits refer to the accumulated earnings of a company since its establishment, minus the accumulated distributed profits. Retained earnings increase when the company earns and records profits, and decrease when it records losses or declares dividends (Ball et al., 2019:7).

3.4 Reserves: Reserves are a portion of retained earnings allocated to cover potential risks. They include legal reserves, special reserves, and capital reserves (Kadhim & Mohammed, 2021:6).

Second: Financial Flexibility
1. The Concept
Financial flexibility is one of the fundamental pillars of financing policies in banks, as it enables them to face crises and avoid funding shortages during times of instability. It is considered a key objective in financial management decisions (Agrawal, 2020:1). Several researchers have introduced the term "Superior Flexibility" to describe a bank's ability to respond quickly and effectively to sudden changes in the economic and market environment by adopting

comprehensive contingency plans that enhance performance stability and ensure sustainable growth (Asim & Nasim, 2022:1). It is also defined as the degree to which a company can mobilize financial resources in order to maximize its value (Mohammed, 2020:11).

2. The Importance

Amid growing economic challenges and continuous fluctuations in financial markets, financial flexibility has become a fundamental pillar for the success and sustainability of banks. It is not merely the ability of banks to adapt to crises, but rather a strategic tool that enables them to seize investment opportunities and effectively manage risks. To understand the importance of financial flexibility more comprehensively, the following key aspects highlight its influence on bank performance:

A. Preserving Investment Opportunities: Financial flexibility enables banks to take advantage of profitable investment opportunities despite funding challenges, which reduces missed opportunities and enhances the benefits of economic improvement (Chortareas & Noikokyris:3).

B. Addressing Future Financial Needs: Flexibility supports making adaptable financing decisions that ensure the availability of liquidity for future requirements, enhancing the bank's preparedness to face upcoming changes and opportunities (Byoun:2).

C. Risk Management and Achieving Financial Sustainability: Flexibility is an effective tool for managing liquidity crises and emergencies, which strengthens financial stability and supports the achievement of regulatory goals (Asim & Nasim, 2022:553).

D. Adapting to Economic and Market Changes: Financial

flexibility allows banks to respond quickly to market fluctuations, thereby supporting growth and enhancing resilience in an unstable environment (Asim & Nasim, 2022:553).

3. Sources of Financial Flexibility

Financial flexibility is a vital factor that enables banks to cope with unexpected economic and financial shocks. It relies on several essential sources:

A. Cash Holdings and Liquidity Management: Maintaining high levels of cash holdings allows banks to cover sudden obligations and reduce the risk of liquidity shortages. It also acts as a precautionary hedge against future fluctuations (Han & Qiu, 2006:43–44). Liquidity management, in turn, is based on determining the optimal level of cash and credit lines to support the bank's financial stability (Almeida et al., 2014:136).

B. Capital and Debt Structure: Using low financial leverage offers greater flexibility, especially in environments with limited access to credit, and helps reduce the risk of bankruptcy. In addition, secured debt can enhance the bank's ability to finance projects without conflict between creditors and shareholders (Li, 2020:6). The study by Ferrando showed that adopting conservative debt policies improves financial flexibility in weak capital markets (Ferrando et al., 2017:87). Furthermore, unused lines of credit are considered an important reserve source of financing (Sufi, 2006:1).

C. Financial Innovations: Financial innovations play a central role in enhancing the flexibility of banks by improving operational efficiency, introducing new services, and developing organizational structures. Key examples include electronic fund transfers, the innovation of ATMs, as well as online and mobile banking services, which enable banks to deliver their services more easily. These innovations are seen

not just as tools for development, but as necessities to confront modern challenges and achieve financial sustainability (Błach, 2011:17; Monday et al., 2024:35).

Section Three: The Analysis Section

This section includes an analysis of a sample of Iraqi commercial banks using a set of financial variables, which are explained as follows:

• Dependent Variable (Y):

The dependent variable is represented by financial flexibility (Y), through which the ability to respond to unexpected changes in cash flows or investment opportunities is examined. This variable was measured using the cash balance ratio.

• Independent Variables (X):

The independent variable in this study consists of several financial indicators, whose effects on the financial flexibility of a number of banks will be measured. These indicators are presented in detail in Table (1).

Table (1): Coding of the Main Dimensions of the Independent Variable and Its Sub-Dimensions

Description	Independent Variable
The ratio of total debt to total assets	X_1
The ratio of total debt to equity	X_2
The ratio of equity to total assets	X_3
Capital adequacy ratio	X_4

Source: Prepared by the

The effect of cross-sectional changes in the financial structure on financial flexibility was examined based on the following hypothesis:

Null Hypothesis H_0: There is no statistically significant effect

of the financial structure on financial flexibility (as measured by the cash balance structure) in the banking sector.

Alternative Hypothesis H₁: There is a statistically significant effect of the financial structure on financial flexibility (as measured by the cash balance structure) in the banking sector.

Table (2) presents the results of analyzing the effect of the financial structure variables (X_1, X_2, X_3, X_4) on financial flexibility through the three models (Pooled, Fixed Effects, and Random Effects), as follows:

It is clear from Table (2) which presents the estimated results of the panel data models for the financial structure in the banking sector based on the hypothesis that the Fixed Effects Model is preferred over both the Pooled and Random Effects Models. This preference is due to its higher coefficient of determination (R^2 = 0.9985), in addition to the statistical significance of the estimated parameters, which showed lower probability values compared to the 5% significance level. Furthermore, the estimated model itself was statistically significant, as indicated by the F-value of 10045.8000 and a p-value of 0.0000, which is lower than the 5% threshold.

Table (2): Estimation of Panel Data Model Parameters for the Financial Structure of the Banking Sector

Variable	Parameters	Pooled Model	Fixed Effects Model	Random Effects Model
	β_0	0.0117	1.1128	-3.9066
Y	T-test	1.8960	605.5597	-1.0361
	Prob.	0.0590	0.0000	0.3010
	β_1	-0.0021	-0.0326	-0.0850
X_1	T-test	-2.0032	-45.9449	-0.1502
	Prob.	0.0461	0.0000	0.8807

X_2	β_2	0.0536	0.0679	0.5084
	T-test	77.8259	388.6692	0.7873
	Prob.	0.0000	0.0000	0.4318
X_3	β_3	0.5223	0.6320	11.1499
	T-test	46.9395	237.3674	1.8474
	Prob.	0.0000	0.0000	0.0657
X_4	β_4	0.0434	0.0046	-0.3030
	T-test	20.5270	8.30623	-0.5935
	Prob.	0.0000	0.0000	0.5533
$\overline{R}^2$		0.9642	0.9985	0.0176
$Adj.\overline{R}^2$		0.9637	0.9984	0.0036
F		1887.46	10045.8000	1.2564
F-Prob.		0.0000	0.0000	0.2874
MSE		284.9983	284.9810	29217.18

Source: Prepared by the researcher based on the results of EViews V.13

For the purpose of comparing the estimation models Fixed Effects and Random Effects the Hausman test was applied to the first main hypothesis. The test statistic (χ^2) reached 7.2775 with a p-value of 0.01219, which is less than 5%. This indicates the rejection of the null hypothesis that favors the Random Effects Model. Accordingly, the alternative hypothesis is accepted, which supports the preference for the Fixed Effects Model, as shown in the table.

Table (3): Hausman Test for the Financial Structure Variables Model in the Banking Sector

Correlated Random Effects - Hausman Test
Pool: BASIC
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.	Sig.
Cross-section random	7.277542	4	0.01219	significant

Source: Prepared by the researcher based on the results of EViews V.13

Discussion of the Fixed Effects Model Results

Table (2) presents the estimation results of the Fixed Effects Model, which describes the impact of banking financial structure variables on financial flexibility (cash holdings structure) as follows:

• The coefficient of the ratio of total debt to total assets was -0.0326, indicating a negative effect on the cash holdings structure. This effect is statistically significant, with a T-test value of -45.9449 and a p-value of 0.0000, which is less than 5%.

• The coefficient of the ratio of total debt to equity was 0.0679, showing a positive effect on financial flexibility (cash holdings structure). The result is statistically significant, with a p-value of 0.0000, below the 5% threshold.

• The coefficient of the ratio of equity to total assets was 0.6320, indicating a positive effect on financial flexibility (cash holdings structure). The test results show this effect is significant with a p-value of 0.0000, less than 5%.

• The coefficient of the capital adequacy ratio was 0.0046, demonstrating a positive and statistically significant effect on financial flexibility (cash holdings structure). The p-value was 0.0000, below the 5% level.

• The Fixed Effects Model of the banking financial structure showed higher accuracy by having the lowest sum of squared errors at 284.9810 compared to other models.

Table (4) illustrates the Fixed Effects Model results based on the impact of the equity-to-total assets ratio and capital

adequacy ratio, reflecting the banking performance levels across banking sectors, where the best banking performance was achieved by…

Table (4) Banking Performance Level for the Fixed Effects Model of the Banking Capital Structure

Banking Sector	Fixed Effects	Effect Coefficient	Financial Performance Level of Banks	Ranking of Banks
Bank of Baghdad	C_1	-0.8843	Negative	---
Bank of Babylon	C_2	-0.8962	Negative	---
Ashur Bank	C_3	-0.6259	Negative	---
Sumer Bank	C_4	8.8290	Positive	1
Al-Etihad Bank	C_5	-0.8012	Negative	---
Gulf Bank	C_6	-0.8835	Negative	---
Middle East Bank	C_7	-0.8348	Negative	---
Credit Bank	C_8	-0.6610	Negative	---
Investment Bank	C_9	-0.6082	Negative	---
Commercial Bank	C_{10}	-0.7758	Negative	---
North Bank	C_{11}	-0.9720	Negative	---
United Bank	C_{12}	-1.0379	Negative	---

National Bank	C_{13}	-0.5465	**Negative**	---
Economy Bank	C_{14}	-1.018144	**Negative**	---
Al-Mansour Bank	C_{15}	1.716492	**Positive**	2

Source: Prepared by the researcher based on the results of EViews V.13

Based on the above, and to determine the most relevant estimated models, a comparison was made using the Hannan-Quinn criterion, as shown in the table below:

Table (5) Comparison among the Estimated Cross-Sectional Models

Model (3) For all Variables	Model (2) X_3, X_4	Model (1) X_1, X_2	Model Criteria
0.0347	0.313932	0.256425	**Hannan-Quinn criteria**
Best Model	×	×	**Decision**

Source: Prepared by the researcher based on the results of EViews V.13

According to table (5) it is evident that the panel data model for the banking capital structure has gained superiority based on the results of the Hannan-Quinn criterion, which relies on selecting the model with the lowest achieved value. Accordingly, the value of the criterion for the general model reached (0.0347), which is significantly low compared to the other models. This preference is due to the general model's inclusion of all explanatory variables in the estimation process, which enhanced the comprehensiveness of the financial structure analysis. This aligns with the econometric dimension of model evaluation, as adopting all variables in analyzing the banking financial structure has demonstrated a greater ability to interpret financial aspects compared to other models.

After completing the econometric analysis of the model that examined the impact of capital structure on financial flexibility within Iraqi commercial banks, a set of findings was reached, shedding light on the nature of the relationship between the independent variables (capital structure indicators) and the dependent variable (financial flexibility). The study relied on four main indicators representing the capital structure: the ratio of total debt to total assets (X_1), the ratio of total debt to equity (X_2), the ratio of equity to total assets (X_3), and the capital adequacy ratio (X_4). Financial flexibility was measured by the cash balance ratio.

The results show that the debt-related variables X_1 and X_2 have a statistically significant negative effect, which aligns with theoretical expectations, confirming that a higher level of indebtedness reduces the bank's ability to maintain liquidity and increases financial risk, thereby weakening financial flexibility.

On the other hand, the equity-to-assets ratio (X_3) has a positive sign, as expected, indicating that higher levels of self-financing enhance the bank's ability to adapt to unexpected conditions.

Conversely, the capital adequacy ratio (X_4) showes a negative sign, contrary to what is theoretically expected. This reverse effect may be explained by several factors, most notably that some banks may hold high levels of capital merely to comply with regulatory requirements, without having sufficient operational liquidity. Alternatively, these surplus funds may be invested in long-term instruments that cannot be quickly converted into cash, which negatively affects financial flexibility.

It is worth noting that, although the capital adequacy ratio may appear high on paper, it does not necessarily reflect immediate liquidity or the ability to respond quickly—especially in the context of Iraqi banks, which face political and economic risks that influence their financial strategies and asset allocation.

Based on the model results, the main hypothesis was tested and subsequently rejected, as it stated that "there is no statistically significant effect of the capital structure on the financial flexibility of the banks in the sample." The findings confirmed that components of the capital structure do in fact have a significant impact on financial flexibility—whether that impact is directly consistent with theoretical assumptions or deviates due to the local context.

Additionally, the first sub-hypothesis, which stated that "there is no statistically significant effect of ownership indicators on the financial flexibility of the banks in the sample," was also rejected. The equity-to-assets ratio had a significant positive effect, while the capital adequacy ratio had a significant negative effect. This indicates a tangible impact of ownership indicators on financial flexibility, even if the direction of influence varies depending on the nature of each indicator.

As for the second sub-hypothesis, which stated that "there is no statistically significant effect of debt indicators on the financial flexibility of the banks in the sample," the results were consistent with expectations. It was found that higher debt ratios lead to a decline in the bank's financial adaptability, confirming a statistically significant inverse relationship between debt and financial flexibility. Therefore, this hypothesis is also rejected.

The study recommends that Iraqi commercial banks should diversify their funding sources to enhance financial stability

and reduce reliance on short-term debt and government deposits. It also stresses the need for stronger capital bases, improved financial inclusion, and risk-based financial policies, along with effective supervision by the Central Bank of Iraq. Moreover, incorporating financial flexibility indicators into periodic reports is advised as a regulatory tool to evaluate banks' performance and resilience.

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