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Factors Affecting Risk Management Practices and Financial Performance of Iraqi Private Banks

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Abstract: This study shows empirical investigating factors that determines risk management practices and its relationship with financial performance among Iraqi private banks. This study is conducted in orderto obtain a comprehensive understanding of the factors behind the implementation of framework on risk management practices found in Iraqi private banks. This study involves 30 Iraqi private banks employees who are working in the selected private banks in Iraq. These employees have experience working in these banks for a period that ranges from between 30-55 years. The interview survey was carried out on the employees consisted of open-ended questions and analyzed through the theme analysis procedure. Interesting results were obtained that linked to organizational factors, top management support and training) (48%) technology capabilities (30%) risk related factor and (15%) financial performance (5%). The aim of this study is to present recommendation and future research regarding to risk management practices which will be subsequently discussed.

Key words: Risk management practices · Organizational · Technology capabilities · Risk related factors financial performance Iraqi private banks · Employees

INTRODUCTION

The financial sector plays an important role in the development of the economy and growth in any country. The banking sector is considered as an important source of financing for most businesses. The past decade has seen dramatic changes in managing risk in this industry. In recent years, supervisors and financial institutions have increased the focus on the importance of risk management (Christine & Beverly, 2001) [1]. In response, banks-both public and private-have almost in all parts of the world embarked upon the upgrading of risk management and control systems. In modern economies, the banking sector is one of the key sectors as; it has become the standards in order to measure the safety of the national economy of any country especially as this sector gets a massive volume of attention (Berger & De Young, 1997) [2].

In recent decades global financial markets have been highly volatile with great changes in foreign exchange, commodity, interest rates and capital flows (Claessens and Jerome, 2004) [3].

Intoday's dynamic global environment, this has become the most fundamental concern in managing risks.However, quantum leap has occurred a way that it displays risk management (Gordon *et al*.2009) [4]. Therefore, this study focuses on the examination of risk management practices in Iraqi banks.

There is no doubt all banks currently have been in a highly volatile environment and are facing a risks such as credit risks, liquidity risks, foreign exchange risks, market risk and interest rate risks, among others these risks may encourage a bank to stay and reap success in the market. Afsin (2010) shows that most daily operations that are performed in banks are risky by nature. For this reason, banks should implemented efficient risk management and this is urgently required. Carey (2001) shows that risk

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management is moreimportant in the financial sector than in the other parts of the economy. The important element in risk management is to create balance between risk and returns and minimize profitsby providingmany financial services, especially by administering risks. Iqbal and Mirakhor, (2007)[5], indicate that exist a strong risk management framework that can help either the public or private banks to minimize exposures to risks and to improve the competitive ability within the market.

Carey (2001) [6], findings indicate that risk management is of great importance in the financial sector than in other part of the economy.Coleman (2007) [7] explored the reasons faced by decision-makers and preferred options, which is a risky alternative.

Gary Stoneburner (2002) [8], has identified that the process of risk management includes nine processes:- “System Characterization, Threat Identification, Sensitivity Identification, Control Analysis, Likelihood Determination, Impact Analysis, Risk Determination, Control Recommendations and Results Documentation”. Therefore, this paper attempts to identify and detect potential factors that may affect the Iraqi private banks implementation of effective risk management practices in turn will affect the financial performance [9].

Banking Sector in Iraq: According to, the National Investment Commission Report (2009), there was 43 banks licensed operating in Iraq. In public-sector there are 6 banks and 36 private sector banks. The public sector banks include the two large commercial banks, Rafidain and Rashid and four special-purpose banks: The Real Estate Bank; the Agriculture Bank; the Iraq Bank (formerly the Socialist Bank) and the Industrial Bank (David, 2007) [10]. This research is important and timely to be conducted in Iraq not only because of the spending of a considerable amount of dollars in managing risk but also because of the lack of such studies that examine risk management in Iraq. Only public banks alone were allowed to lend to public banks enterprises and such lending explains the likelihood of government risk in their books. The private banks in general possessed good capital at the time: the prevailing exchange rate during the pre-war period (officially imposed from government) was \$3.20 to the Iraqi dinar. With the current exchange rates at about ID2, 000 = 1US\$, a bank with a capital of ID 500,000,000 – once worth \$1,600,000,000 – finds itself with a net worth of only \$250,000.1 Thus, the Coalition Provisional Authority (CPA) of the Ministry of Economic Development charged the private banks with an increase in capital to the equivalent of \$5,000,000 within 18 months -ID 10,000,000,000 at the prevailing exchange rate. The financial statement dated 2005 stated that, nearly all of the private banks have fulfilled the new capital requirement but the effects of the Iraq War on banks were devastating, for both the public and private banks.

Under the former regime, banks were strict controlled by the government and have been isolated from the progresses of international advances in technology and business practices. Private Banks have started operating in Iraq in 1992, but were forbidden from doing international transactions (global investment house, 2004). The largest public banks are the al- Rasheed Bank (170 branches in Iraq) the al-Rafidain Bank (153 branches in Iraq) and the IndustrialBank and the Agricultural Bank. Most of these banks controlled 85% of financial assets in Iraq.

Private Banks: The National Bank of Iraq was established as a public shareholding entity in the private sector, to work on the provision of a wide range of banking solutions for the Iraqi market. Due to the growth of the bank and the success achieved in spite of economic fluctuations taking place in Iraq, the bank's capital was raised up to 50 billion Iraqi dinars by June 2009 (43 million). The Capital Bank is the main contributor to the National Bank of Iraq; with contribution of up to 72.3% of the total capital; and become a partner since the beginning of 2004. This represents the first partnership, including enhancing the resilience of the National Bank of Iraq so as to strengthen its position within the Iraqi market. This was especially so with regard to the high credit ceiling enjoyed by the Capital Bank which was granted by the Central Bank of Iraq. This bank supports the operations of the National Bank of Iraq and also the established Bank of the Middle East Iraqi Investment in 1993 with a capital of 400 million Iraqi dinars. There were about twenty-five private banks license dt operate by the Central Bank in the Republic of Iraq in 2006. This compares to late 2003, when there were eighteen private banks licensed and operating, most having to start opening doors in the early 1990s. It was expected that after the second Gulf War, as the situation in Iraq stabilized, foreign investment in the banking sector would start working and take place and there would be a screening of weaker banks and a group of mergers to create larger, more competitive private banks. In fact, despite a certain degree of post-conflict jubilation, foreign investment in the banking sector has been limited to seven banks and no new investments have been made since 2005.

Factors Determining Risk Management in Iraqi Private Banks: Literature studies have pointed out various reasons related risk management practices. Following are the factors believe to be are the determinants of risk management.

Organizational (Top Management Support and Training): The most important factor is support for the top management as the running of the business and the management of risks depend on the decisions made regarding objectives, the banks strategies, activities associated with the management of risks, the missions that have been achieved and the overall objectives that help in the setting up of risk management teams. It also allows for appropriate allocation of resources, effective decision-making to manage risks and also controls and evaluates risks that emerge from the IT sector. (Young2000).

Training: Most new employees in companies undergo training. The main aim her is to improve knowledge, skills, ability and the attitudes of the employees to increase the level of confidence, become motivated and attain job satisfaction.The employees also must adepth to the changing conditions within the operations of the organization especially in the activities that include the development of training courses that are related to risks and the involvement of staff in responding to any early warning system (Carey, 2001). The absence of training programs for the staff leads to the loss of time and effort as well as the loss of human and financial resources.

Technological Capacity: Davis *et al*. (1989) [11] is of the view that the degree by which a person believes self-service banking technologies would improve the performance of handling banking requirements and self-service banking technologies is of importance.

The (Janelle 2006) modelproposes a similar link between technology and perceived ease of use and also a link between technology and perceived usefulness be established.Self-efficacy significantly affects the ease of use all the time, while the use of the system affects the users positively or negatively after first-hand experience with the system. The use of employees in the system is another importantfactor. (Davise, (1998).

Risk Related Factors: Following are the risk related factors:-

Understanding Risk and Risk Management: The Importance of risk management is that the risks increase over time in business, especially in environment of globalization in the financial industry and banking.

Risk management help in the formation of a clear future vision from which to determine the plan for a better banking system (Koch 2006) [13]. It is important for employees to comprehend the aspect of risk encountered in the banking operations and the inherent risks that emerge in the business operations. A better understanding of risk management is essential so that only critical success factors will not be viewed as a technical development, but the ability to understand the risks strategically, as well as the ability to deal with risk regularly.

Risk Identification: The first step in the implementation of risk management would be to establish vital observation areas both inside and outside the corporation (Kromschroder 1998) [14].

Identification of Risks Helps To:

- Rank risks according their importance.
- Help the management develop risk management strategies so as to allocate resources efficiently. (Tchankova, 2002).
- Assign responsibilities to the group that works in the risk department to determine specific risks Non-application of this factor leads to increased multiple types of risks and causes inefficiency in determining the danger zone.(Kromschroder and Luck, 1998).

Risk Assessment and Analysis: This stage is to determine if risks be accepted or not. This decision will be made by the person with the vested authority and who works in the risk department. An acceptable risk should be monitored and reviewed periodically to certify that it is still acceptable. An unacceptable risk should be assessed and be documented to provide a record of the steps taken that has led to the particular decisions taken. This form of documentation will provide a useful reference for future. (Gary Stoneburner, 2002).

Analysis of Risks: Risk Analysis will help one to identify and manage glaring problems that may upset important business initiatives or projects.

There are a number of standards used to minimize risks faced by banks such as (Risk Avoidance, Risk Mitigation, Risk Transference, Risk Acceptance and Risk reduction) (Doherty, 2000; [14] Shimpi, 1999) [15]. Loss control techniques are designed to reduce the severity of a loss, should it occur. From this point, in Iraqi private banks there some steps taken to analysis risks, especially credit risks, instead some tools are used to avoid risk but truly this needs the ability to use tools efficiently, in addition to, understanding risks and risk management and to pay attention to all types of risk faced by banks.

Institutions should set up effective management information systems (MIS) to monitor risk levels so as to facilitate reviews of risk positions and exceptions. Inefficient risks monitoring caused profit losses, increase lack of confidence and bankruptcy. The lack of monitoring of risks result in the loss of the opportunities for success in understanding risks and in the identification of loss, as time and effort will be wasted. This step needs the provision of a quick report which would be ready so as to avoid risks. Supervision of Financial Intuitions (2007).

Credit Risk Analysis: The critical problem faced by banks is credit risk.The major single cause of bank failure is more often than not the result of credit risk. Common reaction to credit problems is: (Credit concentrations). This is the concentration of credit to a single client with a high volume of wealth and avoids from being presented to other clients. This poses high risks (Saad, 1998) [16]. The inability to analyze credit risk leads to the loss of customers which will the result of in the failure of fulfilling the obligations of the Bank's customers, the loss of required liquidity to be provided and this in turn will lead to the loss the opportunities to invest and get revenue.

Financial Performance: The process of financial performance is a continuous and necessary to improve the performance of the banking facilities, as a result of identifying the pros and cons of the activity within the organization and achieving goals. (Eccles 1991).

The first step to analyze the situation and evaluate the performance is to make decisions on achieving goals of the bank so that the performance is directed towards these goals (.Eccles, 1991) [17]. The bank therefore seeks to achieve the following:-

- The bank's reputation and increase in financial value.
- The efficiency and effectiveness of the administrative system achieving the goals of innovation through the provision of high-quality services.
- Employ efficient staff to achieve the highest reputation and top banking service.
- Increase customers who in turn will lead to the achievement of goals. Any weakness in using these methods will leads to the loss of the parties contributing to such as applicants and owners and will shake the confidence of the bank. This in turn will leads to the failure of the bank and the loss of the rights of the shareholders.

MATERIALS AND METHODS

Although many studies have been conducted regarding risk management practices in developing countries itis still is at the minimal level in Iraq context. Therefore, this paper presents the different variables that might have influential factors for Iraqi private banks in performing risk management practices. In a written interview survey question conducted among Iraqi private employees, an open-ended question was asked (does your bank implement a framework of risk management? If yes do you think that your banks understanding of the concept of risk and risk management will enable the management of risk?). Different answers were gathered from 30 employees who were participants of the interview survey. The findings discovered that using a step-by-step analysis called theme analysis was put into practice. The first stage begins with the researcher distributing written interview question and collecting answer from the participants. The researcher then read, sorted, checked and scanned the answers in order to determine the factors and issues addressed in the research questions. Finally, the researcher classified each response into various themes. Then data was then put into tabulated columns in percentage for discussion.

Data Analysis: There are 30 employees received the questionnaire but one of them avoid answer and this reflected on r ideas, expertise and performance. Figure 1 show on the factors affecting the implementation of risk management practices among Iraqi private banks and its percentages.

Figure 1 shows organizational and technology capabilities are the two main factors selected by the participants 48% and 30% in ranking. From these

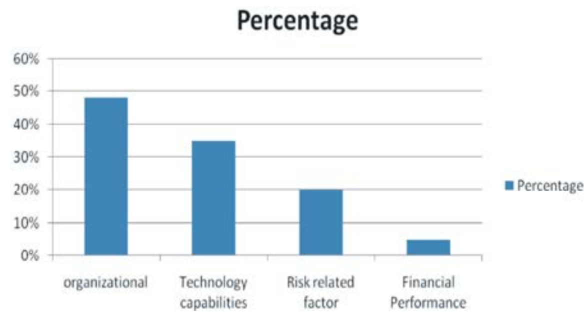

Fig 1: Factors Determining Risk Management in Iraqi Private Banks

percentages, the researcher founded that the majority of employees had personal issues related to the factors affecting risk management practices in Iraqi private banks. Thus, these issues either directed or encouraged avoidingsuch practices related to risk management. Most of the respondentsfelt that risk management practices were needed in banks to reduce risks. The other rated response was based on more than70%. The remaining 5% responded that there was alack infinancial performancethat affected risk management practices in Iraqi private banks [18].

Organizational: Organizational factor shows that the feeling of apprehension and the lack of confident existed in getting involved with the non-face-to-face transactions. (The employees might feel afraid of being too arrested or we are from other ministry in Iraq because bad situation throughout the process. For example, the image shows banks may not possess good sources to support employees and provide courses training. In other words, what they receive may not enough to encourages from banks to applying risk management practices.

Most employees are aware of the need to manage risks they and are willing to practice risk management according to the required or stipulated terms and conditions that would pave the way to do so. That means that the organization is one of important factors affecting risk management in banks. This in turn will help to promote desertion-making and minimize losses in the futureand maximize successes (Jordan, 2000). Researchersare now convinced that top management support can help in the application of effective risk management.Furthermore these applications will help toincrease the provision of training program which will in turn help to save time and effort at the same time increase employees' products.

Technology Capabilities: The important thing for employees is to work with confidence and safety and learn everything new and learned from the experiences of others to develop and produce.Technology, despite being expensive, works to increase confidence in the workplace and enables the staff to be in line with this strategy. Self-efficacy significantly affects the ease of use all the time, while the use of the system affects the users positively or negatively after first-hand experience with the system. The use of employees in the system is another important factor.

Some respondents have justified that in terms of usefulness, it useful for banking business, or for the use by the employees. The effect on banking business was also looked into and an increase in the intensity of competition was also identified.

Using technology significantly affect the ease of use at any time and when the employees use of the system after first -hand experience with system it can result in either negatively or positively result (Carry, 2001). Unfortunately, it should be noted that all trainingcourses rely on intimate relationships so there was no indication of any positive result from the training in banks. Many technologies have been developed to manage risk but all of them pose a challenge to be chosen which is convenient it can help in the reduction of risks occurring.

Risk Related Factor: Risk is defined as anything that can create hindrances to the achievement of certain objectives Afshien, (2010). Banks are exposed different types of risks such as credit risk, liquidity risks, market risk, interest rate risks and other type of risks. In addition to theelectronicsbanks new types of risk in the form of fraud risks that had been emerged, in this respect the banks need to be ready to confront and avoid risks these risks and a proper framework is required for that. Iqbal and Mirakhor, (2007), showed that a strong risks management framework can help either the public or private banks minimize the exposures to risks and improve the competitive ability within the market. The important of an implementation of the framework in dealing withrisks has increased over time in businesses, especially in an environment of globalization in the financial industry and in the banking sector as well, Help is available in the form of a clear future vision from which to determine the plan and implementation in thebanking sector. Technological revolution has led to the creation of a new multiorientation within the banks as a result of electronic banking, which has led to the emergence of additional risks associated with electronic banking. Risk assessment and hedging against what does not affect the profitability of the bank can be attained through the use of risk management instruments and viaassistance in coming to pricing decisions. (Koch *et al* 2006).

Moreover, the implementation ofrisk management encompasses three processes: risk assessment, risk mitigation and evaluation and assessment. This guide shows that the risk assessment process, which includes identification and evaluation of risks and risk impacts, provide recommendationsfor risk-reducing measures. Risk mitigation, which refers to prioritizing, implementing and maintaining the appropriate risk-reducing measures have been recommended via the risk assessment process. The continual evaluation process and keys for implementing a.

A successful risk management program is of vital importance. The system's authorizing official is responsible for determining whether the remaining risk is at an acceptable level or whether additional security controls should be implemented to further reduce or eliminate the residual risk before authorizing (or accrediting) the system for operation.Gary Stoneburner, Alice Goguen and Alexis Feringa, (2002).

Financial Performance: Loth (2008) dined the financial performance as the company's ability to generate new resources, from day to day operations, over a given period of time. The success of the bank and the increase of its revenue process are in the control of the risksas well as the elimination of these risks.

Al-Dorry (2000) and Jbara (2000) [19], who proposed that financial performance, have provided a measure of success for the organization and the achievement of its objectives.

The absence of support from the top management, training, lack of assessment and analysis of risks, mismatch with new technology, failure to monitoring risks, inefficient staff in managing credit risks due to the absent of effective management system have hampered the organization from achieving its objectives. (Izdihar report, 2007, SAHAR NASR, 2011). The combinations of these factors have a negative impact on the efficiency and the performance of risk management among the staff and other departments in the banks which lead to failure in achieving the banks' objectives. Past experience of other banks which is positive in nature results in the respondents where bye employees fails to get involved with such transaction. This study indicated only less than 70% of the response ;the existing framework has not been validated in the Iraqi private banks to reduce risk. Some were of the view that there is a lack of experience in risk management practices, thus recommended the development ofa training program and that would supply a new version of technology. However, there was also a group of respondents who shared experience in related to the usefulness of conducting risk management practices. Some on the other hand, confessed of never having heard about the framework for risk management practices previously that would reflect not only the educational background, but also experiences [20-22].

CONCLUSION

This paper has identified factors resulting from interview conducted with employees in Iraqi private banks regarding to the performance of risk management activities in their banks. The study found that organizational and technology capabilities are important factors that can have either negative or positive effect on the implementation of risk management in banks and can help to reduce risks identified by the respondents up to 48% and 30% respectively. In this regard, these percentages help the researchers to conclude that most of the respondents had personal issues pertaining to the implementation of risk management practices in the banks. Consequently, these issues either directed which were deemed important to implementation of the framework for risk management practices in order to reduce and avoid risk. This indicates that organizational and technology capabilities play as critical role in the implementation of risk management frame work the result reflected on better performance in banks. In addition, organizational and technological capabilities are also existing factors that increase the frequency level of the implementation of risk management activities. From these findings, the researchers further concluded that these factors will generally lead to higher and in depth intention for these factors to implement risk management framework to reduce risk in Iraqi private banks. In light of numerous studies, it is recommended that future quantitative research be carried out in future studies for the purpose of validating qualitative results in this study.

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