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THE IMPACT OF NON-PERFORMING LOANS ON FINANCIAL PERFORMANCE IN A SAMPLE OF IRAQI COMMERCIAL BANKS – (THE BANK OF BAGHDAD IS A MODEL)

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Abstract

The process of granting loans from banks is considered as the trust they give to their customers, but this trust should not be a basic foundation when granting loans, even if these loans are granted according to sound banking principles, which entail risks that the bank may be exposed to due to the customer's refusal to fulfill his financial obligations to the bank. Perhaps due to the unexpected economic conditions that affect customers, which puts them in a state of default, which weakens the ability of banks to provide loans, which is considered one of the most important sources of achieving returns and profits for banks. Therefore, the problem of non-performing loans is considered one of the main problems facing most banks, which hinders their work. Among the reasons that led to the exacerbation of the problem of banking default is the lack of soundness and study of credit decisions in the event of granting loans, errors in the economic feasibility study, failure to adhere to the procedures and controls of credit policies within the bank, in addition to the embezzlement and theft to which the bank is exposed, and the inefficiency of banking management. To avoid this problem, it is necessary to Study it carefully, using scientific methods with regard to credit decisions and guarantees, which differ according to the type of loan. In the case of long-term loans, their risks are high, as the problem lies in the Bank of Baghdad, which is the largest Iraqi bank here, with the high volume of non-performing loans in it and its incurring large losses due to bad loans, which affected This negatively affects its profits and reserves, and the bank deducts a portion of its profits to meet unrecovered debts allocated to doubtful debts despite the decrease in its capital. This is due to the Bank of Baghdad's failure to adhere to the instructions of the Central Bank of Iraq, especially with regard to the adequacy of capital and the guidelines for credit classification, which reflects the inefficiency of the bank's management. In addressing the problem of defaulting loans**.**

Keywords: Non-Performing Loans, Financial Performance

INTRODUCTION

The banking system is considered one of the most important pillars of the national economy in any country given the importance of the services it provides to society, so commercial banks represent the main focus because of their important role in building both the national and global economy, as they work to accumulate deposits that are surplus to the needs of the public and establishments. Business or state and reinvest it for the purpose of lending it to others .The process of granting loans from the bank is considered the trust that it places in its customers, and although it is considered an essential element of the lending process, it does not guarantee

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that the bank will protect it from the risks to which it is exposed when granting those loans. This is due to the possibility of events or influences occurring that hinder the borrower and prevent him from fulfilling the loan. With its obligations towards the bank, in this case, the bank's rights over the borrower become at risk, and loans that reach this situation are called non-performing loans .Defaulting bank loans is considered one of the complex economic problems and is of concern to banks due to the extent of its risk, as it leads to the freezing of part of their funds and affects the financial performance of the bank .The impact of non-performing loans, liquidity, and financial performance in commercial banks has received wide attention because they are considered one of the recent topics that have not received their share of study and research.

The studies conducted on commercial banks were limited, especially in Iraq, so we will try through our study to identify the impact of non-performing loans. On the financial performance of commercial banks in Iraq, relying on a standard model, a method that has gained great interest because it mixes time series data and cross-sectional data .The problem of the study was formulated with the following main question: What is the extent of the impact of non-performing loans on the financial performance of Iraqi commercial banks? To answer the research question, the researcher developed a hypothesis that can be proven or denied through the study, which states that there is a statistically significant effect at the level of significance (5%) for non-performing loans on the financial performance of the commercial banks under study .To test this hypothesis, the standard descriptive analytical statistical approach was relied upon in collecting and processing data based on data models using the (9-EVIEWS) program.

1. THE CONCEPT OF NON-PERFORMING LOANS

The bank defines default as the project facing internal and external circumstances that lead to its inability to generate a financial return or cash surplus from activity revenues sufficient to pay its obligations, especially short-term obligations. From a legal standpoint, default is the insufficiency of the debtor's funds to fulfill his obligations and debts due for payment, while the economic concept of default is the inability to fulfill obligations owed despite an increase in assets over liabilities[1].

A non-performing loan has been defined as that debt whose repayment terms between the bank and the customer are subject to fundamental violations that result in the inability to collect the installments and interest of the loan, which can be said to mean that there are strong possibilities for it not being repaid, even partially.[2] Non-performing loans are also known as the inability of the borrower to service the debt, which is represented by the principal amount in addition to the interest accrued on it on the maturity dates, and the loan turns into a non-performing loan (irregular) because its risk level is higher than the maximum normal risk level for existing loans, and that is According to the standards established and specified by the banking supervisory authorities in the country concerned[3] .Also known as non-performing loans, it is the condition or situation in which the loan agreement, especially the repayment terms, faces the risk of violation or breach, which exposes the bank to potential losses. Default means the inability to repay or delay the installments and interest due[4].

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The researcher believes that a non-performing loan means the inability of the creditor to pay the loan installments along with its interest on time, partially or completely. Some argue that the loan is considered non-performing if the debtor exceeds the specified due date.

2. REASONS FOR LOAN DEFAULT

There are several reasons that lead to loans defaulting, as there are reasons related to the bank granting the loan, reasons related to the borrower, and other reasons outside the control of both the bank and the borrower, that is, reasons related to the external environment, and these reasons can be highlighted[5]. Among them are the reasons related to the bank: Banks often fall victim to their own mistakes and not just the mistakes of others, and thus the problem of bad debts represents, in one of its basic aspects, the problem of the bank itself. This is considered a failure to observe the conditions that must be met in the guarantees provided to the bank in terms of ownership, mortgage, storage or possession, the laws regulating transactions, their sale, the conditions for their storage, the suitability of the warehouses to store the goods...etc., and the failure to make accurate, periodic and renewed inquiries about the types of goods. Provided as a guarantee, the prices of which are characterized by extreme volatility, or the consumer or user will withdraw from them, and the exchange of guarantees among the bank's customers, which leads to the total guarantee not covering the amounts of the credit facilities granted to these customers, and allowing the customer to use the facility funds in one go while it should These funds should be used in installments according to the business need and the timetable prepared in this regard.

Also, refraining from providing additional financing to the client, which is usually minimal, so the business falters and the client stops fulfilling the bank's obligations, and then the bank is exposed to the risk of losing all or some of the loan. Also, the bank's insistence on Requiring the customer to pay in one payment without taking into consideration the circumstances he is going through, due to which the customer may be exposed to default, complimenting the customer by granting him more facilities than needed, leniency in converting temporary (short) debt to permanent (long), and expanding the granting of credit for high-risk projects, as well as When making a credit decision, the profit side prevails over the risk side, as a balance must be achieved between profit and loss, allocating a large percentage of loans and credit facilities to one borrower, or directing a large percentage of loans to a specific economic activity and neglecting other activities, and making the decision to grant loans based on pressures. It is practiced by other parties, as well as the bank's lack of interest in banking personnel, through appropriate qualification and training and their lack of sufficient availability, which leads to default.

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As for the reasons related to the client, they include recent experience in the activity, the use of loans for a purpose other than their intended purpose, a quarrel or separation of partners, the client's disdain for the bank's instructions and directives or his failure to adhere to the conditions and controls set by the bank for him, the use of the financing provided for the project and his failure to provide follow-up data or provide it. In a way that is consistent with the bank's desires, but without being reflective of the reality of the existing conditions in the financed project, which then results in making wrong decisions that are inconsistent with the current conditions in the project.[6]

As well as the loss of the financial and administrative ability to plan, organize, direct and follow up on the various investment operations in the project, and thus the lack of ability to control the movement of funds in it, and the lack of separation between the client's own funds and the funds of the project he manages and thus using part of the project's funds to spend on his private and family needs, which It leads to the consumption of part of the project's capital and causes it to become insolvent, or the client expands his borrowing in the name of the project to cover his personal expenses, and does not provide the correct data and information to the bank when requesting financing or during it, and exaggerates the pricing of the price of the goods as a result of the client's appreciation of the markets. It may also not take into account the principle of competition. Taking into account this results in a decrease in sales with an increase in costs, an expansion of operating expenses disproportionate to the volume of sales, and serious irresponsibility and mismanagement of borrowed funds, especially if the workers are not the owners of the project."

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There are also reasons related to the external environment[7] For example, there are some deflationary phenomena that have appeared in the markets recently and have led to an expansion of the terms specified for them, which leads to a decrease in the customer's returns and thus his inability to pay the bank on the scheduled dates, and force majeure or a sudden accident, which is something that cannot be expected or avoided, such as a fire. Or the occurrence of an earthquake that destroys the funded project, intensification of competition, high costs of insurance and pensions, government intervention in pricing policies, high rates of inflation and interest rates, and the local market is limited and lacks the ability to absorb and absorb production, flexibility, spontaneity, and lack of integration of market structures, and thus it is not encouraging to do By establishing large-sized companies because the market does not accommodate the massive production of modern production units, the difficulties of procuring foreign exchange in the face of the growing deficit in the state's balance of payments and the continuous decline in the value of the local currency against foreign currencies......

Therefore, it must be taken into account not to allow the project to obtain Medium- and long-term loans and facilities in foreign currencies whose default does not increase as a result of the rise in the exchange rate of foreign currencies at rates higher than the profitability of the projects. The failure of legislation to keep pace with the requirements of economic and financial openness and the failure to adapt local legislation to confront international legislation or changes in bank activities or methods lead to assistance in default. Loan.

3. THE CONCEPT OF FINANCIAL PERFORMANCE

Financial performance is a narrow concept of business performance, as it focuses on the use of simple ratios based on financial indicators that are supposed to reflect the establishment's economic objectives. Most researchers have agreed that financial performance as a concept depends on the process of financial analysis, which is defined as a series of financial methods that can they are used to determine the strength and weakness of an organization. Financial ratios are mainly used in this analysis in order to compare past performance with current and expected performance and to identify areas of difference. Financial performance is defined as the results of the outputs obtained from processes and products. It expresses the outputs or goals that the system seeks to achieve. It is a concept that reflects each of the goals that the organization seeks to achieve[8]

Financial performance is also defined as expressing the evaluation of the economic unit's activity in light of the results it has achieved at the end of a specific financial period. It is concerned with achieving the planned and defined goals in advance, and measuring the unit's efficiency in using the available resources, whether they are human or capital resources[9].There are main objectives for financial performance in institutions, including measuring and evaluating the level of success of the institution by striving to continue its activity in order to achieve its goals and providing information to various entities and levels outside the institution, and contributing to the development of policies, programs, future studies and research that work to improve performance levels and raise its efficiency. By providing information and a database about the institution's performance, and estimating the level of impact of financial

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performance tools such as profitability, liquidity, debt, and stock distributions, which makes it possible for the investor to know the nature of the institution's activity and follow it, in addition to the possibility of monitoring the circumstances surrounding the institution, and helps the investor in making appropriate decisions for the situation.

The institution because it helps in conducting analysis, comparison and interpretation of data and understanding the relationship and interaction between financial data, which enables the investor to make the right decision [10] Financial performance is also characterized by several features that enable the institution to succeed in making optimal use of the financial means available in order to achieve its goals, the most important of which are: a tool that gives a clear picture of the current financial situation in the economic institution, and motivates management to exert more effort to achieve better future performance than its predecessor, and a remedy tool. The deviations and problems that the institution may face, identifying the strengths and weaknesses, and the means of attracting investors to invest in the institution.

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4. FACTORS AFFECTING FINANCIAL PERFORMANCE

There are a group of factors that affect the financial performance of companies and they can be explained as follows[12]. Including the size of the bank: Classifying companies into large, medium, or small is one of the factors that affect financial performance, and may cause an obstacle to their financial performance. As the size increases, management becomes more complex, and it requires increased financial analysis to reach a more detailed financial plan. Organizational structure: The organizational structure affects financial performance through assistance and understanding in preparing strategic plans successfully by defining the required goals and activities, allocating resources and clearly defining orders to help in making optimal decisions. Number of employees: The number of employees is considered a variable asset and shows the size of Its work and productivity, which affects the return on investment, as the number of employees often affects the quality of services, and thus affects the strength or weakness of the bank or company, which affects investors' willingness to buy shares, and stock returns and interest rates are affected: the interest rate is considered the main driver.

To invest capital and transfer it between stocks and bonds as an alternative opportunity for investment, especially if it is high, as the investor prefers to put his money in banks to obtain a stable return, and a high interest rate leads to a reduction in borrowing operations, which affects financial performance outcomes directly, and age: plays Age is a major factor in influencing

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profitability. The older the age and the greater the good reputation, this leads to having greater experience in enhancing financial performance, and gaining the trust of beneficiaries more than those that have a short lifespan or are new in origin. Also, electronic services: Technology plays a major role in Differentiation between companies, and it is important to adapt to technological developments and modify performance, as they cover different aspects of competitiveness, reducing costs to increase profits and market share, and inflation: The continuous rise in the general price level is considered one of the factors affecting financial performance, and its effects are evident through preference in distribution. Among the categories, as prices increase, production increases and thus profit increases. Social culture: Social culture and banking awareness affect the profitability of banks, which affects the market share of deposits and loans and the profitability of these banks. Price fluctuations: Price fluctuations and the risks accompanying them contribute to changing prices. Unexpected exchange between currencies, and due to the increase in international trade, this contributed to higher rates of dealing in foreign currencies, especially in light of fluctuations in the exchange rates of different currencies.

5. APPLIED STUDY

The stage of describing the econometric model is considered the first and basic step taken by the researcher in econometric studies who wants to study a specific economic phenomenon. It means expressing the phenomenon in a mathematical formula in order to reflect the various relationships. This stage is called the hypothesis formulation stage, and it includes the following steps:

- **Define model variables**

Variables	Symbol
Non-performing loans/independent variable.	**BL**
Total cash to total assets.	**CF**
Total cash to total deposits.	**CD**
Return on assets.	**EA**
Return on equity.	**EP**
Capital adequacy ratio.	**CA**

- **Determine the mathematical form**

A description of the mathematical form of the model, the number of equations it contains, which may be one equation or more than one equation), the degree of linearity of the model (it may be a linear or non-linear model), and the degree of homogeneity of each equation (it may be homogeneous or heterogeneous at a certain degree). A. Economic theory does not explain The exact mathematical form of the model may, however, sometimes clarify some information, so some researchers resort to some methods that are useful in determining the mathematical form. In this study, the mathematical form of the model can be determined as follows:

BL=F(CF,CD,EA,EP,CA,LI)

BL=B0-B1CF-B2CD-B3EA-B4EP-B5CA-B6LI+μ

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➢ The program used in the analysis

The 9-E-Viewe statistical analysis program was used to analyze the data. The 9-E-Viewe program is considered one of the latest programs in the field of standard analysis.

➢ Testing the stability of time series data for study variables

In this case, the unit root test is used to determine whether the study variables are stationary at their level or when calculating the first and second differences. The most important of these tests are:

• Expanded Dickey-Fuller test

The Dickey-Fuller test is considered one of the most widely used tests in scientific applications. Below are the results of the Dickey-Fuller test for the study variables.

The model: The impact of non-performing loans on the financial performance of the Bank of Baghdad.

Table (2): Results of the extended Dickey-Fuller test (stability of level-1 and first- and second-difference time series)

stability level of the variable	test statistic	significance level%5	Variables
First team	-6,199	-3,320	**CA**
First team	-8,235	-3,259	**CD**
The second team	-17,693	-3,320	**CF**
The second difference	-3,878	-3,320	**EP**
First team	-3,693	-3,259	**LI**

Source: E-views program.

We note from the results of the table above that the variables CA, CD, LI stabilized in the first difference at a significance level of 5%, while the variables CF, EP stabilized and stabilized in the second difference at a significance level of 5%, while the variables BL, EA were outside the range of stability at a significance level of 5. %

• Correlation matrix

This can be explained through the results of the following table:

Table 3: Correlation matrix

	BL	CA	CD	CF	EA	EP	LI
BL	1,000	0,420	0,819	0,841	-0,170	-0,874	0,809
CA	0,420	1,000	0,652	0,644	-0,271	-0,192	0,123
CD	0,819	0,652	1,000	0,981	-0,213	-0,099	0,473
CF	0,841	0,644	0,981	1,000	-0,080	0,032	0,585
EA	-0,170	-0,271	-0,213	-0,080	1,000	0,889	0,210
EP	-0,087	-0,192	-0,099	0,032	0,889	1,000	0,298
LI	0,809	0,123	0,473	0,585	0,210	0,298	1,000

Source: E-views program.

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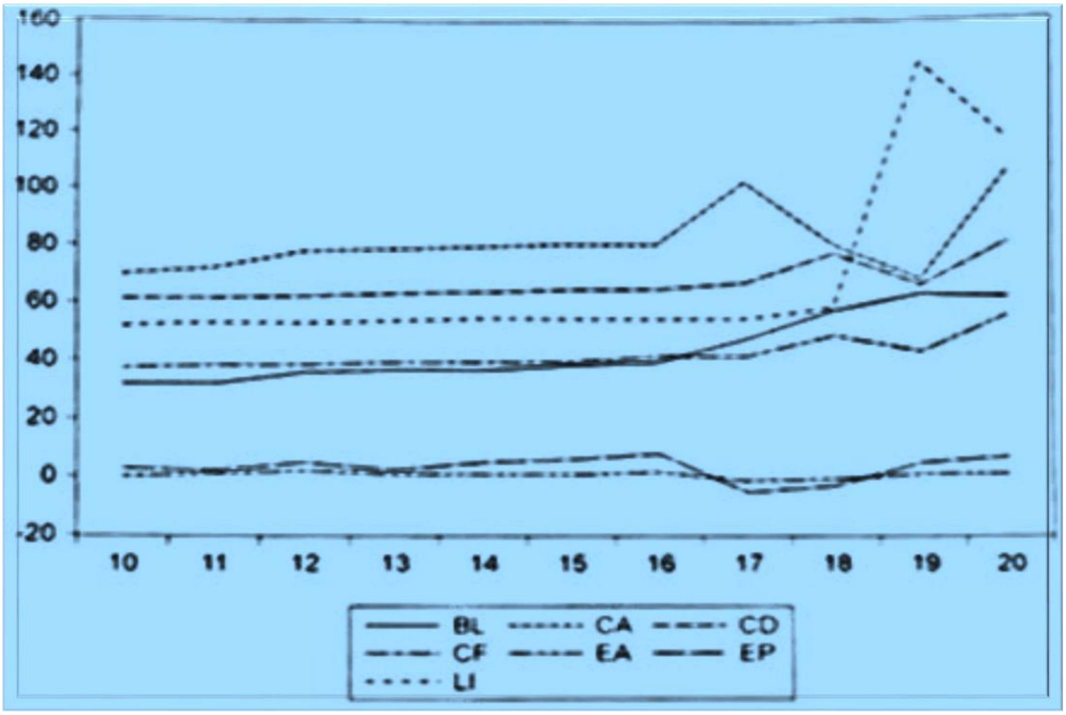
From the results of the table above, there is no linear correlation between the variables and that there is no linear correlation problem in the model.

Figure No. (1): The graphical form of the model



Source: E-views program.

- **Estimated model.**

This can be explained through the results of the following table:

Table No. (4): Estimated model for the Bank of Baghdad

Variable	Coefficient	Std. Error	Test Statistic	Prob
C	-74,266	35,706	-2,079	**0,10**
CA	0,067	0,155	0,436	**0,068**
CD	3,498	1,923	1,818	**0,14**
CF	3,498	2,514	-1,342	**0,25**
EA	-3,376	2,943	0,606	0,57
EP	1,786	0,640	-0,944	0,39
LI	-0,321	0,075	4,280	0,01
R^2=96%		**D-W=1,44**	**F- Statistic=17,47**	

Source: E-views program.

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Table No. (5): Excluding non-significant variables

Variable	Coefficient	Std. Error	Test Statistic	Prob
C	23,050	5,590	4,122	**0,002**
LI	0,308	0,074	4,131	**0,002**
R^2=65%		**D-W=1,26**		**probf=0,002**

Source: E-views program

We note from the results of the table above that the increase in bad debts led to an increase in the liquidity ratio. This is contrary to the meaning of economic theory. The reason is that the increase in bad debts reduced the provision of sufficient amounts of investments. The increase in liquidity is due to the increase in outside banks.

• Error correction model.

Table No. (6): Error correction model

Variable	Coefficient	Std. Error	Test Statistic	Prob
C	-0,098	0,062	-1,581	**0,165**
COINT E(-1)	0,608	0,232	2,618	**0,0397**

Source: E-views program

We note from the results of the table above that the error becomes 60% in the short run, reaching cointegration in the long run.

6. RESULTS

Commercial banks play an important role in financing and economic development operations by providing the necessary funds for this. Achieving more profits is considered the primary goal of any bank's management, which is mainly linked to the future employment of its funds in various forms, which is considered one of the most dangerous functions that it exercises because these funds are not their property, but are Money of its depositors. However, banks often fall into crises and losses that shake their entity and stability as a result of several circumstances that occur to them during their activity, and among the factors and circumstances that directly affect banks are non-performing loans.

The problem of non-performing bank loans and liquidity is considered one of the most serious problems to which banks are exposed, which places them in critical circumstances and situations. This is because of the imbalances it causes to it that hinder its activity and threaten its financial stability. It is an issue that requires increased intellectual and practical efforts to accomplish the task of managing and controlling it. It is a process that goes beyond the scope of banks and borrowers, as it requires the integration of all dimensions and aspects in order for the treatment to be completed and achieve its goals, and through...

Our study of the various aspects of the problem of non-performing bank loans and liquidity and its impact on the financial performance of commercial banks, and after projecting elements of the theoretical side onto the applied study that we conducted on five Iraqi commercial banks (Bank of Baghdad), results were reached through which it is possible to prove or deny the

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validity of the hypothesis adopted for this study.

The results of the model test proved: The impact of non-performing loans on financial performance in the Bank of Baghdad. It was proven that the increase in non-performing debts led to an increase in the liquidity ratio. This matter is contrary to the meaning of economic theory. The reason is that the increase in non-performing loans reduces the provision of sufficient amounts of investments. The increase in liquidity is due to an increase outside the banks, and the error becomes 60% in the short run, leading to cointegration in the long run. The model also proved that there is no linear correlation between the variables and that there is no linear correlation problem in the model.

7. RECOMMENDATIONS

Based on the results of the study and taking them into account, some recommendations can be presented regarding this topic:

- Paying attention to developing human resources and forming banking frameworks according to international standards.
- Serious attention and careful study of the customer's creditworthiness before granting him a loan.
- Taking seriously the problem of non-performing bank loans because the significant increase in their percentage reflects negatively on the performance of banks in general.
- The need for the Central Bank to apply strict laws and procedures to banks in order to control such a problem.
- Banks must commit to implementing effective systems in the field of credit risk management and work to develop banking risk management with expertise and specialization
- We recommend that the banks under study take into account the high volume of non-performing bank loans because it affects profitability, which reflects negatively on creditworthiness.

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