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The Impact of Non-Depository Financing Sources on Capital Adequacy

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Abstract

The research aims to demonstrate the impact of non-depository financing sources on the capital adequacy of Gulf Commercial Bank listed on the Iraq Stock Exchange for the period (2016-2022). The researchers relied onthe method of analyzing financial data for the research sample. The research problem revolves around the question of whether non-deposit financing sources have an impact on capital adequacy. Therefore, the research hypothesis was formulated as follows: Non-deposit financing sources affect capital adequacy.The researchers reached several conclusions, the most important of which is the existence of a very weak relationship between non-deposit financing sources and bank capital adequacy.

Keywords: *Non-deposit financing sources, capital adequacy, cash reserves, income tax allocation, other liabilities.*

Theoretical Perspective

1- Concept And Definition Of Financing

First: The Concept Of Financing:

The field of specialization in finance emerged independently at the beginning of the last century, and the focus of this specialization was initially on corporate formation and merger operations, which were the central concerns of thinkers. This continued until the 1920s when the focus shifted towards seeking new sources of investment financing, the field of finance began by addressing the types of bonds that companies can issue to obtain financing. During the global recession in 1930, there was a shift in the focus of financial interest from the expansionary activities of companies to another activity that aligns with global developments, which is the search for how to build companies and deal with bankruptcy issues. There was a significant focus on restructuring organizations, their liquidity, and regulating financial markets (Abu Al-Rab, 2002: 46).

The origin of the term "finance" refers to currency, which is a broad concept in economic activities involving all aspects of life. No individual, organization, or country can operate or sustain their livelihood without money. Similarly, economic units such as banks and companies require financing to cover their needs and fund their investments (Al- Mayah, 2019: 180). Finance is considered a complementary part of general management in economic units, rather

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than being considered a consulting specialization that deals with obtaining the necessary financing for projects and the cost of each source of these funds, which varies depending on the size and nature of the projects. Financial markets are considered a primary source of funds according to financial experts (Hawas, 2021: 36)."

Secondly, The Definition of Financing

The definition of financing has varied with different perspectives and can be summarized as follows:

- A series of decisions related to methods of attracting the necessary funds to finance bank investments, and determining the appropriate and optimal mix of borrowed and available funding sources, as well as private funds to cover its investments (Youssef, 2010: 210).

- Providing the necessary funds to pay for the costs of private or public projects and their development, through the provision of money (Farah, 2014: 3).

- The process of providing funds or financial resources to enable individuals, companies, or institutions to carry out their activities and projects (Noor, 2013: 44), which can be short-term, medium-term, or long-term (Al Maghribi, 2020: 7).

- Therefore, financing is one of the most important aspects that stakeholders are concerned about, due to its impact on the stability of banks and protecting them from bankruptcy, and it represents the left side of the public budget (Qadir & Al-Haidari, 2023: 4).

Thirdly: Determinants of Differentiation Between Sources of Financing

The bank has a number of sources of financing and it must choose one of these sources. In the first stage, the available alternatives of financing sources are identified, and then the cost of each alternative is compared and the alternative with the lowest cost is chosen. Then comes the second stage, through which the risks of each alternative are determined and the capital structure of the company is formed. In other words, the financing decision is the choice of financing sources through which the necessary funds will be raised to finance the bank's investments. (Al-sadi & Al-mamouri, 2022: 3)

In the stage of choosing the appropriate source of financing, it is necessary to identify the characteristics of each financing source, and in general, the characteristics of various financing sources revolve around four points: Nabeel, 2017: 68)), (Hussein & Aya, 2021: 16)

1. Maturity Date: Each loan has a specific agreed-upon maturity date between the bank and its creditors, and it must be repaid on that date, whether the loans are short-term, medium-term, or long-term.
2. Fulfillment of Obligations and Profitability Level: Debt contracts require the bank to pay a certain interest or a portion of the debt with interest. Therefore, the bank must fulfill those commitments regardless of the level of achieved profits, and it should not be exposed to legal actions that may lead to its liquidation. Creditors have priority in payment over shareholders in the income or profits generated by the project.
3. The stability of the payment value: Debt contracts between the bank and the creditor require the former to bear fixed burdens as a consideration for using the funds of the second party, regardless of the level of profits earned. For example, if the interest is 10% annually of the loan value, the interest must be paid regardless of the amount of profits earned and for the duration specified in the loan contract.
4. Guarantees: They are represented by all the movable assets owned by the borrower that can be pledged to the bank to obtain the loan (Al- Jaldeh, 2000: 102)

The purpose of obtaining financing is to meet the capital needs of the bank, whether they are short-term financing needs related to the operating cycle or long-term financing needs related to the investment cycle. It should be noted that there are several factors to be considered when choosing a source of financing, including the amount of funds required and the time period, as well as determining the scope of use (investment). The cost of financing is calculated and compared with the expected return. Other factors include profitability, risks, investment capacity, and the bank's reputation (Ben Sassi, (Qurashi, 2011: 238)

Fourthly, Financing in Banks

As banks provide services to the public, whether industrial, commercial, or agricultural, they contribute to achieving economic development according to their respective specialties. They work on managing production, exchange, and promoting capital accumulation, among other vital transactions that contribute to prosperity and progress (Areqat, 2017: 59). This is done through providing credit facilities. Banks act as intermediaries between deficit units and surplus units, accepting deposits in exchange for interest and lending to investors at higher interest rates. The sources of financing in banks include internal sources (shareholders' capital) and external sources (deposits and savings) (Makawi, 2019: 73). In Islamic banks, this is done through interest-free banking services, with the aim of achieving the economic dimension through investments in projects and contributing to the Gross Domestic Product, while also achieving social and environmental aspects in accordance with Islamic law (Hamdan, 2020: 6).

Fifthly: The Need for Financing

The bank needs short-term financing to finance its operating cycle, and long-term financing to finance its investment cycle. The importance of short-term financing lies in the following: (Karima, 28: 2015), (Dulaimi, 2018: 37), (Musa, 2019: 45):

1- The need for short-term financing: Banks use this financing to cover liquidity shortages resulting from internal activities. Bank credit covers a significant portion of current assets and is the main driver of current operations. This type of financing depends on the nature of the bank's business or activities. This financing is used for the following reasons:

a- Low risks: This relates to creditors, meaning that the short repayment period of debts makes investors more willing to invest these funds due to their susceptibility to risks and their ability to predict what may happen to banks, and thus obtain funds according to agreed-upon terms.

b- Usually, obtaining this financing is less expensive than other types (medium-term or long-term financing) due to short repayment periods and low risk rates.

c- Banks have a need for financing for seasonal periods, so they seek this type of financing to cover immediate liquidity shortages and fund those needs.

d- Some financing cases can be interest-free, meaning that banks do not incur any costs to obtain credit in cases of deferred payment until the agreed-upon period is settled.

Banks also need long-term financing to cover the costs of their long-term investment activities, in order to acquire production means, equipment, or properties such as lands, industrial, commercial, and administrative buildings. Especially since financing through stock investment is considered one of the most important and challenging steps in investing in the securities market as it is accompanied by risks. (Ismail,& Jihad, 2022: 1) In comparison with other institutions or organizations, the government obtains the largest share of financing (Ibrahim, & Al-Haidari, 2022: 5).

Sixth: Non-Deposit Financing Sources

Deposits are not flexible and are not subject to the control of central banks. Banks cannot control the amounts they receive from deposits, and they do not know when deposits will arrive or flow to them, or how much and when they will be withdrawn in the near future. This is a problem that banks constantly face, and they may find themselves in urgent need of new and alternative sources of financing or non-deposit financing sources that enable them to meet their needs in terms of the amount of funds, stability, and cost (Al-Wadi, 2017: 38). Non-deposit financing sources include the following:

A. Borrowing from the Central Bank

The Iraqi Central Bank is the final choice for commercial banks to borrow from. Commercial banks only resort to borrowing when necessary, and they issue bonds when they want to invest and expand, as bonds carry a lower interest rate than investment returns (Samhan et al., 2010: 162). The Iraqi Central Bank is also considered the bank of banks, overseeing various banks and the country's banking system. It provides loans and advances to commercial banks in times of financial crisis, emergencies, or when borrowing from other channels is unavailable (Dahham et al., 2019: 10).

The borrowed funds from the central bank are not subject to legal reserve requirements, so commercial banks can use all loans to finance their investments. Therefore, they represent the investment power of commercial banks and the banking system as a whole. The central bank provides financing to commercial banks either directly through loans and advances or through discounting their commercial papers, unless the banks have liquidity, in which case they prefer to hold the bonds until the maturity date to be able to invest the funds. The original holder of the paper does not look favorably upon discounting it because it may reveal some of their financial secrets. Similarly, the commercial bank itself is dissatisfied because a request for discounting may be misinterpreted by some as evidence that the bank does not have sufficient liquidity to meet customer demands for available cash (Al- Sayrafi, 2013: 49).

Re-discounting is one of the oldest forms of assistance provided by central banks to commercial banks, but the importance of this source is due to the banks having sufficient funds and the existence of many different markets and activities in these countries, so the importance of this source has declined as the spread of financial markets has become a good place to sell securities instead of discounting them at the central bank. (Ramadan & Jawda, 2013: 93) Especially as bank management faces significant difficulties in attracting and retaining customers due to competition among banks to provide the best for the customer and the existence of various alternatives in the market (Jassim & Al-Heidari, 2021: 5).

B - Borrowing from Commercial Banks

Commercial banks are banks that receive deposits in various forms, demand deposits, fixed deposits, savings deposits, and in return provide all types of loans and offer customers documentary letters of credit or collection and withdrawal of banking services bonds (sukuk) for clients and perform other banking services (Abdah, 2020: 14). Commercial banks also sometimes lend to each other to meet their own financing needs, but they are hesitant to do so because borrowing from another bank may indicate a flaw or weakness in the borrowing bank (Al-Mousawi, 2010: 51). Banks obtain these loans based on bilateral arrangements, preferential terms, and interest rates, although some of these loans are based on guarantees, interest rates, and other conditions provided by market mechanisms. Borrowing from other banks takes the following forms: (Kannan, 2012: 188), (Berger, 2016: 44), (Hanafi, 2019: 67).

A- Commercial banks can open current accounts or term accounts or deposits by notifying other banks in order to dispose of excess liquidity and transfer it to another bank in exchange for investment.

B- The local bank retains a certain amount in the foreign bank account (correspondent bank) for transfer transactions, and pays documentary credits or other obligations.

C- There is a loan agreement between two banks; the first bank does not need liquidity while the second bank needs to invest in it due to increased demand for borrowing. In this loan, the time between banks, interest rates, and other revenues are determined.

D- An agreement between a local bank and a foreign bank to provide loans for the purpose of foreign currency investment. Usually, the interest rate and repayment period are agreed upon in the loan contract, and the interest rate is determined at the lowest rate. According to the current interest rate system, these forms of loans help the borrowing bank to provide liquidity and increase investment, thus increasing the profit of the borrowing bank and financing the desired economic sector. Commercial banks rely on borrowing from local or foreign banks or from the Central Bank of Iraq as some of their resources. This source of financing varies from bank to bank according to the characteristics of the prevailing banking system in the country and the relationship between banks. (Qader,& Al-Haidari, 2023: 5)

C- Required Reserve Surplus Loans

The bank deposits a certain percentage of the deposits in the bank account to meet the cash reserve requirements. Since the establishment of the Bank of England, the central bank has been responsible for the cash reserve. Commercial banks are committed to depositing a certain percentage of the deposits in their bank account with the central bank (Frederic, 2016: 39). As a result, the cash reserve changes in response to changes in the deposit balance. When the deposit balance decreases, the cash reserve turns into a surplus that can be loaned to other banks (Shuwish, 2019: 187).The legal reserve is the percentage imposed by the central bank on the banks' deposits as a legal requirement (Fadel,& Ismail, 2019: 4)

D- Repurchase Agreements

Repurchase agreements are similar to required reserve surplus loans between banks but involve more complex procedures.

This agreement is defined as the sale of a highly liquid security with a promise to repurchase it from the buyer at a later date and at a predetermined price in the contract (Al- Shubaily, 2012: 4) It is also referred to as a form of short-term borrowing in which the bank commits to repurchase the sold security upon maturity (Michael & Kenneth, 2003, 1)

The basis of these agreements is that when the bank needs funds, it applies for a loan from a bank that has a surplus or marketable high-quality security. In this case, the lender must agree on the quality and quantity of these securities, and the borrower expresses readiness to repay the loan. The loan is repaid by purchasing those securities at the end of the contract period at a fixed price or specified interest rate. This interest rate is lower than the interest on the reserve surplus loan because it contains a guarantee (Ghazi, 2014: 405) The common name for this type of agreement in the financial market is a "Repo" agreement, which is usually short-term and falls within cash market operations (Hubbard,2008, :281).

Seventh: Capital Adequacy

1- Concept of Capital

Capital is an economic term that refers to the funds, materials, and tools necessary for establishing an economic or commercial activity. The goal of the project can be profit, information, or humanitarian work. Capital is the main driving force for any project or investment that aims to increase productivity. It is also the main measure of the wealth owned by the economic unit and the primary resource that helps it increase that wealth (Al-Saeed, 2016: 46)

Capital is defined as the money or other assets owned by individuals or entities that are used for wealth development, increasing wealth, or establishing new projects (Brooking, 2017: 23). The importance of providing capital for different projects lies in providing the foundations for production, supporting increased production, and promoting economic development. Capital is calculated based on the size of the project to be established (Agndal, Henrik and Nilsson, 2015: 17).

2. The Concept of Capital Adequacy:

means having sufficient capital to absorb losses arising from credit, investment, and other additional activities carried out by the bank (Mohammed, 2014, 39). The uniqueness of banking operations and their association with multiple and conflicting parties at the same time highlights the importance of capital adequacy for these parties. Central banks, through their vision of capital and reserves compared to the size of deposits, are concerned with capital adequacy to prevent the bank from becoming insolvent. The goal is to protect the funds of depositors and shareholders and, consequently, protect capital (Heisie, 2016: 27). Capital is considered the most important precautionary tool for regulation, serving as a preventive measure to achieve stability in the banking system at both the partial and overall levels. The Basel Committee on Banking Supervision has encouraged banks to maintain more capital reserves to be used later in achieving banking stability due to its significant role in absorbing losses (Globe & Haidari, 2023: 7).

3- Capital Adequacy Ratio

Banks face various risks, which may come from internal factors related to the bank's activities and management, or from external factors resulting from changes in the bank's working environment. Therefore, banks use different methods to hedge against these risks (Al-Banna, 2017: 20)

and one of these methods is establishing a bank policy to protect and support the bank. This policy is called the capital adequacy ratio, so banks strive to maintain sufficient and appropriate capital to carry out their various activities in the areas of lending, investment, and deposit-taking. Capital risks are manifested in the inadequacy of capital to cover the obligations of the bank and protect the funds of depositors and creditors, which requires keeping sufficient capital to absorb any potential losses the bank may incur (Al-Wa'ili, Al-Zubaidi, 2020: 9) The capital adequacy ratio refers to the approach followed by the bank's owners and management to achieve a certain balance between the expected risks of the bank and the size of the capital (Williams ،2015: 59).

The importance of capital adequacy in banks has significantly increased since the 1970s when the world witnessed massive changes that had a negative impact on banks. As a result, manifestations of financial crises emerged, especially the difficulties and obstacles faced by banks and the public financial sector (Brooking ،2017: 41).

The interest in the concept of capital adequacy increased after the Basel Committee on Banking Supervision approved its unified standard for bank capital adequacy in 1988, which later became the international standard for indicating the financial strength of the bank and increasing the confidence of its stakeholders (Shahin, 2013: 46). The minimum capital adequacy ratio considered necessary by the regulatory authority to comply with Basel II for internationally active banks and large banks is that capital should be (8%) of risk-weighted assets, and banks must also adhere to international financial reporting standards for their benefits and effectiveness in achieving fair disclosure. The agreement aims to: (Shihab & Hamdan, 2021: 4).

A - Develop methodologies for measuring and managing bank risks.

B - Achieve the highest possible alignment between the required capital amount and the level of risks faced by the bank.

C - Enhance dialogue and understanding between bank officials and national regulatory bodies in measuring and managing risks and the relationship between capital size and risks.

D - To increase transparency of the bank's risks, sufficient information must be provided in a timely manner to those who deal with the bank because they participate in the risks faced by the bank.

2- The Practical Aspect

1- Research Sample

The research sample is represented by the Gulf Commercial Bank listed on the Iraq Stock Exchange, a joint-stock company established under the founding certificate numbered M.SH/7002 on 20/10/1999 issued by the Companies Registration Department, in accordance with Law No. (21) of 1997, with a fully paid-up capital of (600) million dinars. The bank started its operations through the main branch on 1/4/2000 after obtaining a banking license from the Central Bank of Iraq numbered S.A/9/3/115 on 7/2/2000, in accordance with the provisions of the Central Bank of Iraq Law No. (64) of 1976 in effect at that time, to engage in comprehensive banking activities. Its founding contract has been amended several times to increase its capital to reach (300) billion Iraqi dinars, after completing the legal procedures on 7/11/2014 by the Companies Registration Department, according to its letter numbered (26790).

Note that the bank owns (18) operating branches within the country, five of which are located in the areas of the capital Baghdad, and fourteen branches in other provinces, in addition to owning (11) international correspondents distributed in Arab and international countries.

2**.** The researchers relied on the financial data of the research sample to analyze the data and determine the extent of the impact of non-deposit financing sources on capital adequacy during the research period (2016-2022). Table (1) shows the financial data of the research sample, which demonstrated non-deposit financing sources including cash, income tax, other liabilities, long-term loans, and deposits and ownership and total assets .

Commercial Gulf Bank data Table (1)//

Year	Cash Insurance	Income Tax Allocation	Other Liabilities	Long-term Loans	Total Non-deposit Financing Sources	Ownership Equity	Total Deposits	Total Assets	Liabilities
2016	44286022	1084716	9941401	1775266	57087405	317733784	427200844	802022034	484288250
2017	5816661	810860	8319297	1675266	16622084	320887340	265803562	603312989	282425648
2018	4896375	1126036	22830980	2075266	30928657	314472925	232934933	578336518	263863593
2019	3621926	______	35225945	2008628	40856499	306709058	201579972	549145530	242436472
2020	3087189	107770	16405108	3258628	22858695	307172111	180767475	510798283	203626172
2021	3341056	_____	18912554	6944848	29198458	304325776	204966518	538490754	234164978
2022	3618788	_______	9516637	5833175	18968600	308640863	225447864	553057328	244416465

Based on table (1), the percentage of each source of non-deposit financing was calculated as a proportion of the total non-deposit financing sources, as shown in table (2).

Table (2) Percentage of Non-deposit Financing Sources to Total Non-deposit Financing Sources for Gulf Commercial Bank

Year	Cash Insurance Ratio	Income Tax Allocation Ratio	Other Liabilities Ratio	Long-term Loans Ratio
2016	77.5	2	17	3.5
2017	35	5	50	10
2018	16	4	74	6
2019	9	___	86	5
2020	13.5	0.5	72	14
2021	11.44	________	64.77	23.78
2022	19.08	________	50.17	30.75
Highest Ratio	77.5	5	86	30.75
Lowest Ratio	9	0.5	17	3.5

Source: Prepared by the researchers based on the bank's financial data

Table (2) illustrates the increase and decrease in the share of each source of non-deposit financing to the total non-deposit financing sources, indicating the bank's reliance on each type of financing for its activities. For example, the highest percentage was for cash reserves (77.5%) in 2016, indicating an increase in deposits and documentary credits and guarantees. The lowest percentage was in 2019, reaching 9%. The same applies to the rest of the financing sources. The highest percentage for income tax allocation (5%) was in 2017, providing the bank with an opportunity to invest in this source more than other years.in addition to relying on other requirements and long-term loans with high percentages in 2019 and 2020 respectively, as shown in the table, the bank also heavily relies on other requirements to finance its investments. This is because the first and second sources have restrictions on their use for funding the bank's activities, as the first is linked to the bank's commitment to repay deposits, and the second is linked to income tax repayment. As for the last source, long-term loans are linked to the bank's capital operations.

Table 3 also discusses capital adequacy indicators. The researchers relied on four ratios to calculate capital adequacy: capital to deposits ratio, capital to risk-weighted assets ratio, capital to total assets ratio, and capital to loans ratio.

Table 3 Capital Adequacy Indicators for Gulf Commercial Bank

Year	Capital to Deposits Ratio %	Capital to Risk-Weighted Assets Ratio	Capital to Total Assets Ratio %	Non-deposit Financing Sources to Liabilities Ratio
2016	74.38	89.24	40	12
2017	120.72	125	53	6
2018	135.00	131	54	12
2019	152.15	148	56	17
2020	169.93	143.837	60	11
2021	148.48	33	57	12
2022	136.90	34	56	8
Highest Ratio	169.93	148	60	17
Lowest Ratio	74.38	33	40	6

Source: Prepared by the researchers based on the bank's financial data

As shown in Table 3:

1. The highest capital to deposits ratio was 169.93% in 2020, and the lowest ratio was 74.38% in 2016. In both cases, we observe a significant increase in the ratio compared to the specified ratios according to Basel III regulations or the instructions of the Central Bank of Iraq, which are set at 8% and 10% respectively. Based on this ratio, the adequacy of the bank's capital is evident in terms of the available funds to meet its obligations significantly exceeding what is required of the bank. This means that the bank enjoys financial solvency and has the ability, through relying on the capital adequacy ratio, to face potential losses.
2. The capital adequacy ratio to risk-weighted assets for Gulf Commercial Bank reached its highest ratio during the year 2019, reaching 148%. The lowest ratio reached 33% in 2021, which is higher than the required limit according to Basel Committee (3) decisions regarding capital adequacy (8%) and the Central Bank of Iraq instructions (12%). Some rely here on the appropriate capital for the bank based on the assets in which it invests its funds, meaning the investment portfolio, and the required amount is low when the investments have low risks. Conversely, others believe that capital is sufficient if the investments do not exceed six times the capital. In this case, the investments are approximately one and a half times the capital.

Table (4) presents capital adequacy indicators based on non-deposit financing sources as shown below:

Table (4) Capital adequacy indicators based on non-deposit financing sources

Year	: Cash Insurance Ratio %	Income Tax Allocation Ratio %	Other Liabilities Ratio %	Loans Ratio%	Total Non-deposit Financing Sources Ratio %
2016	7	293	31.96	179	5.57
2017	55	396	38.57	192	19.30
2018	64	279	13.77	152	10.17
2019	85	___	8.71	153	7.51
2020	99	2850	18.72	94	13.44
2021	91	___	16.09	44	10.42
2022	85	___	32.43	53	16.27

It is evident from the table (4) the impact of non-deposit sources on capital adequacy and their varying percentages. The highest percentage was in the year (2017), reaching (19.30%), meaning that the bank has the necessary funds to cover non-deposit sources of financing, noting that capital adequacy is based on deposits in the year (2017), amounting to (120.72%). It is clear here that the major weight is given to deposit financing sources, which have a greater influence on capital adequacy compared to non-deposit financing sources, which were less than the specified ratio of (10%) in the years (2016 and 2019) during the research period.

Conclusions

Based on the analysis of financial data, the researchers reached several conclusions, the most important of which are:

1- The bank achieved a capital adequacy ratio that exceeds the required level, relying on risk-weighted assets, which represent the most important aspect that the bank seeks to cover due to its risks.

2- The bank relies more on deposit financing sources than non-deposit financing sources, therefore their impact is greater on capital adequacy. However, this does not negate the impact of non-deposit financing sources as long as they are a source of financing, but their impact depends on their contribution to the total external sources of financing.

Source

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