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Banking Methods to Reduce the Risks of Credit Facilities

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Abstract

There is no credit without risks, as risks are synonymous with the credit facilities provided by banks to clients. However, banks strive hard through their prudent credit policies to limit the risks associated with credit facilities, relying on several methods and techniques to minimize these risks to the lowest possible level. Therefore, this study concluded that banks follow two methods for reducing risks. The first is proactive methods which is obtained before granting credit facilities. They are either preventive, initiated by the bank before the risks occur and represented in good inquiry about the client before granting the facility, or remedial, represented in insuring against these risks. On the other hand, the second methods are reactive methods after granting credit facilities, which are also either preventive, imposed by banks before the risk occurs and represented in monitoring credit facilities to ensure that the granted credit is used according to the terms and rules that were given to it. Or remedial, which banks resort to when credit risks occur, represented in debt restructuring.

Keywords: *Bank methods, credit facilities, risk reduction.*

Introduction

Businesses are exposed generally to various risks that threaten their operators, yet, these risks are particularly evident in the services provided by banks, especially credit services provided to investor clients. Banks face many risks due to their dynamic structure and the complex nature of the economic environment in which they operate. However, credit risks associated with granting credit facilities have been and continue to be one of the most sever risks that monetary institutions face because the credit process involves significant risks for both the bank granting the credit facility and the borrowing client, or risks arising from non-parties to the credit facility contract. Therefore, banks seek to limit these risks through their credit policies. Banks adopt two methods to limit or mitigate these risks. They are preventive methods that banks follow before risks occur, and remedial methods that banks resort to after risks occur. (de Almeida & Neto, 2003)

Preventive methods to limit credit facility defaults

Banks follow several methods in their credit policies to limit the risks associated with credit facilities. These methods involve studying the client's creditworthiness and monitoring credit facilities in terms of how they are spent. We will discuss these methods in details.

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Credit study for the borrower

Time plays great importance in the field of credit, as credit is based on the element of trust that the bank gives to its client in providing a sum of money for a specific purpose and within a certain period. Therefore, there is a time difference between the date on which the bank grants the credit amount to the client and the date on which the client pays back the debt to the bank. During this period, the client's financial situation may fluctuate, making them unable to fulfill their commitment to the bank, and this is the real meaning of risk (Ahnert & Kuncl, 2015; Ahmadi et al., 2022). The bank may lose not only the interest it aspired to, but it may also not be able to recover the credit facilities granted to the client. Risk is an integral part of credit decisions since it is difficult to have a risk-free credit decision. The essence of the credit decision is to try to control and limit these risks to the lowest possible level (Awad, 2020). Therefore, banks resort to revise credit to secure their interests by knowing the client's creditworthiness. Studying credit regulates credit and accurately determine the bank's clients, indicating their ability to repay (Hussein & Abdul Razzaq, 2021; Crespo-Martínez et al., 2022) , and the value of collateral provided in exchange for credit facilities by linking them through a network among banks (Al-Taher, & Al-Shukri, 2015). The policy of disclosure and transparency is an essential part of the bank's credit policy, which the bank follows in order to develop banking operations (Al-Yassin & Abd al-Khaliq, 2016).

The credit studying is an organized and continuous effort according to established and defined rules and concepts, and various methods with the aim of providing the bank's credit decision-making body with a set of data and information that helps them make sound credit decisions (Abdulqader, 2008).

The purpose of the study is not limited to providing data and information to the bank, but the investigator can recommend not to deal with the client under study, provided that there are justified reasons for this recommendation (Al-Yassin & Irahim, 2017; Herlambang et al., 2022).

The bank's commitment to credit study is a positive action that involves collecting information from various sources to form a clear and integrated picture of the borrower (Al-Khudairi, 1987, 184). The department of credit study in the bank is responsible for inquiring about credit-seeking clients. It is responsible for identifying, collecting, sorting, classifying, operating, analyzing all data and information that the bank's management in general and credit management in particular need, extracting effective information from it, and sending it to the credit decision-maker (Amin. & Hussein, 2019). It is worth mentioning that banks aim through their credit studies to determine the financial and credit position of their clients (Abdelmoghni, 2016), as well as to know the effectiveness of the credit policy applied by the board of directors. This is because the credit policy determines the types of information and data that credit management requests from the borrower for analysis and examination (Al-Alfi, 1997; Kunama & Leeratanavalee, 2023)

One might wonder where banks can obtain the data and information related to the credit-seeking client. Article 30 of the Iraqi Commercial Law No. 30 of 1984 states that "the commercial register operates on the principle of transparency, and every citizen may request to access its contents and obtain a certified copy of these contents for a fee...". This corresponds to Article (1/32) of the Egyptian Trade Law No. (17) of 1999, as it stipulates: “1. Each person may obtain from the Commercial Registry Office a copy extracted from the registration page…”. Therefore, the bank can obtain this information from the Chamber of Commerce if the client is a merchant, or from various administrative authorities to verify the accuracy of the

information provided by the client. The bank can also approach professional associations or obtain this information from its own records if there have been previous dealings between the bank and the credit-seeking client. Additionally, some laws have established private companies that banks can use to collect information about credit-seeking clients (Hussein & Shweesh, 2019). Additionally, some laws have established private companies that banks can use to collect information about credit-seeking clients (Haentjens & de Gioia, 2020; Lello et al., 2023).

These companies are known as credit rating agencies. Article 112 of the Iraqi Central Bank Law and the Egyptian Banking Law stipulates that "the board of directors may license companies to provide credit inquiry and rating services related to the indebtedness of bank customers, real estate finance companies, and leasing companies... The credit inquiry and rating company must take the form of an Egyptian joint-stock company, and its issued and paid-up capital must not be less than two hundred million pounds". Article 9 of the UAE Credit Information Law No. (6) of 2010 matches with this Article 112 of the Iraqi law. Likewise, Article 1 of the basic decision related to regulating the relationship between banks and credit rating companies issued by the Central Bank of Lebanon No. 9641 of 2007. Credit rating agencies are a large repository of information (Maarouf, 2013; Lluch et al., 2023) They take the form of joint-stock companies. Their nature of work is to create credit files by collecting, processing, and storing personal and credit information, in addition to providing credit rating services and issuing credit reports to inquirers (Abbas, 2019). The importance of credit rating has increased because it facilitates the procedures for granting credit facilities. This is because the credit-seeking client is evaluated by a third party (credit rating agencies), that are not parties to the credit process (Mahdi et al., 2010; Shen, 2022).

It is noted that Iraqi legislation lacks regulation for credit rating agencies, and it does not specify the authority responsible for granting licenses. Therefore, it is suggested that the Iraqi legislator to amend the Central Bank Law to allow the Central Bank to license credit rating agencies, which would help banks make sound credit decisions. Moreover, there are other sources from which the bank can obtain information, such as the credit-seeking client themselves. It is customary for the client to fill out a special form when applying for credit facilities, which is then submitted to the relevant bank employee. Additionally, the act of applying for credit facilities indicates the client's seriousness in obtaining them (Al-Yassin & Irahim, 2017; Ruiz & López, 2023).

Another question that comes to mind is what kind of data and information the bank requests from credit-seeking clients. Referring to the Central Bank Law of Iraq and the Egyptian banking law, it is noticeable that the Egyptian legislator obligated that natural or legal persons applying for credit facilities provide information about the names of establishment owners or shareholders, their percentage of ownership in joint-stock companies, degree of kinship if any, and the amount of debts owed by the applicant. The creditworthiness of the client must also be established through a credit study, which should indicate that they have sufficient financial resources to fulfill their current and future obligations. The bank must take necessary care to verify the accuracy of the information provided by the client. In contrast, the Iraqi legislation requires banks to obtain a copy of the credit-seeking client's identity card, residence card, and passport. However, we believe that any identification issued by Iraqi authorities should suffice to verify the client's identity.

Credit facilities monitoring

The credit process does not end with the granting of credit facilities to clients, but extends to the utilization stage (Al-Alfi, 1997). The legislation obliges credit-granting entities and monetary

authorities to monitor credit facilities to prevent defaults (see the text of Article (15 / Sixth) of the instructions to facilitate the implementation of the Iraqi Banking Law (IBL)). Therefore, we will discuss the monitoring of credit facilities through the following two sub-sections:

Credit facilities monitoring by the bank

The credit policy of banks includes the establishment of an integrated system for monitoring credit facilities. Periodic checks are conducted to verify that the client is using the granted credit facilities for the purpose specified in the credit contract. Clients are prohibited from using credit facilities for purposes other than those specified in the credit contract (See, Article 104 of the Egyptian Central Bank and Banking System Law). To ensure compliance with regulations, systems, and credit policies, considering the general economic conditions of the country and the client's circumstances (Al-Shawarbi & Al-Shawarbi, 2002; Yin et al., 2023).

Banks must follow the directives and decisions of the Central Bank that affect the credit path. The bank must also identify problems with debt collection and any developments in clients' credit positions that may affect their ability to repay debts on time (Al-Khudairi, 1987). If it becomes apparent through monitoring that the client will not be able to fulfill their credit obligations by the agreed-upon deadline, the bank must balance between postponing payment or taking legal action against the client to protect its rights as a credit-granting institution (see Article (15 / Sixth) of the instructions to facilitate the implementation of the IBL).

The success and effectiveness of the credit monitoring system depend on the necessity of maintaining a credit file for each borrowing client that includes data and information taken from various sources, financial statements from credit studies, and audit reports (Article (46/5) of the IBL). The bank's representatives also prepare reports on visits and discussions with the client and the results that emerge from them (Al-Khudairi, 1987). It should be noted that banks must monitor the implementation according to the conditions listed in the credit contract. It is important to ensure compliance with laws, regulations, and supervisory instructions, as well as internal instructions specific to the bank granting credit facilities (Hussein & Shweesh, 2019).

These instructions vary from one bank to another according to the credit policy it adopts in managing its credit operations (Al-Khatib, 2005). If it becomes apparent through monitoring that the client has used the credit for a purpose other than that specified in the credit contract, the bank may demand the contract's termination with compensation if applicable. Article (1/177) of the Iraqi Civil Law No. 40 of 1951 stipulates: “In contracts binding on both sides, if one of the two contracting parties does not fulfill what was required of him in the contract, the other contracting party may, after giving notices, request termination with compensation if it is required...". Likewise, the text of Article 246 of the Jordanian Civil Law No. 43 of 1976, and Article 157 of the Egyptian Civil Law No. 131 of 1948.

If the responsibility for monitoring is within the bank's board of directors' duties, it is exercised through specialized departments according to the bank's regulations. Credit monitoring is typically carried out by branch management, credit management, inspection management, monitoring management, and audit management, among other tasks within the limits that achieve coordination in this regard to present the results to the bank's board of directors (Saleem, 2016).

Credit facilities monitoring by the Central Bank

Credit facilities monitoring is not limited to banks only. The Central Bank also performs this process as one of its main functions. This is because it is primarily responsible for regulating and controlling the money supply to stabilize the general price level (Falhi, 2019). This does

not mean an absolute freeze of prices at a particular level, but rather a reasonable degree of relative stability in prices to achieve economic stability (Dowidar, 2007). Banking monitoring is defined as a set of measures taken by regulatory bodies, primarily by the central banks, to maintain the safety of bank assets, retain a good level of liquidity while achieving fair and reasonable profits, protect the national economy from any crises and deviations, and protect depositors, shareholders, and creditors (Aughi, 2002). The Central Bank performs this function through several mechanisms, including:

Firstly, the quantitative credit monitoring, or indirect monitoring

It refers to the tools used to influence the total amount of credit in the banking system, regardless of its intended use. This type of monitoring is achieved by influencing the level of cash reserves in the banking system, which then indirectly affects the total volume of bank credit and investments (Al-Hazza, 2019). The central bank uses several policies to influence the total amount of credit available in the banking system, including:

1. **Open market operations policy:** refers to the central bank's buying or selling of securities on the financial market, such as treasury bills, government bonds, and other short- or long-term securities, either directly or through the market. This is done by dealing with individuals, companies, and banks. In Egypt, this policy is defined as "the operations carried out by the central bank to inject or withdraw liquidity from the banking system, such as linking deposits or issuing certificates of deposit or other instruments, as well as dealing with the purchase or sale of securities and financial instruments issued by the central bank, Egyptian government securities, government-guaranteed securities, and other bonds designated by the board of directors," (Article 1 of the Egyptian Central Bank and Banking System Law).

Referring to the Iraqi banking legislation, we did not find a definition of open market operations, except that, in accordance with the Iraqi Central Bank Law, it authorized the central bank to engage in open market operations (Article (28/a) of the Central Bank of Iraq Law No. 56 of 2004, corresponding to the text of Article 43 of the Central Bank Law and the Regulation of UAE Facilities and Regulations No. 14 of 2018).

This tool has a direct impact on the amount of cash reserves held by commercial banks (Shakir, 2020), and on interest rates. If the central bank buys securities from commercial banks and pays them in cash, their cash reserves increase. This leads to a flexible credit policy with easy conditions for granting credit facilities, which in turn reduces interest rates due to increased demand for securities resulting from an increase in the money supply. This increases investment in times of recession. In times of inflation, the central bank sells securities on the market, and commercial banks pay for them in cash, which reduces their cash reserves and weakens their ability to grant credit facilities. This leads to a strict credit policy with high interest rates, which in turn reduces investment (Khalil, 2006).

2. **The discount rate policy:** is another tool used by the central bank to influence the amount of credit. The discount rate is the rate at which the central bank discounts commercial papers presented to it by commercial banks. This is the percentage deducted by the central bank when purchasing commercial papers presented to it by commercial banks seeking liquidity through discounting these papers (Al-Ayadi, 2014). If the central bank wants to reduce the amount of credit available in the financial market, it raises the discount rate on commercial papers presented to it by commercial banks. This forces these banks to raise their own discount rates and interest rates on their clients, making the cost of credit facilities high and reducing demand for them, ultimately leading to a decrease in the amount of credit. Banks may also be

forced to refrain from expanding credit in order to maintain sufficient reserves that protect them from turbulent situations (Kenawy, 2005). However, if the central bank wants to increase the amount of credit available in the financial markets, it lowers the discount rate on commercial papers, causing commercial banks to lower their own discount rates and interest rates on credit facilities. This leads to an increase in the amount of credit available in the market (Al-Hallaq & Al-Ajlouni, 2010).

3. The reserve requirement policy: refers to the requirement imposed by monetary authorities on commercial banks to deposit a certain percentage of their present cash holdings with the central bank without receiving any compensation. The amount of this percentage is determined by looking at the total balances of customer deposits held by commercial banks. The central bank's ability to control the amount of credit and manage monetary policy is achieved through this tool (Shakir, 2020), (See Article 29/1 of the Central Bank of Iraq Law). By raising or lowering the reserve requirement percentage, the excess reserves held by commercial banks increase or decrease, affecting their ability to grant credit facilities. If we assume that the central bank raises the reserve requirement percentage on current accounts, this would lead to a decrease in the bank's ability to use the balances in these accounts to grant credit facilities. Similarly, raising the reserve requirement on investment accounts also affects the commercial bank's ability to achieve profits that could have been achieved. All of this leads to an increase in costs for banks, forcing them to raise interest rates when granting credit facilities or to lower interest rates on deposits held with them (Khalil, 2018).

Secondly, the qualitative monitoring of credit facilities

The central bank uses it to influence the amount of credit granted by commercial banks. While the quantitative tools indirectly affect the credit policies of banks, qualitative monitoring can directly impact the amount of credit granted (Kanaan, 2012). The national economy's interest may require encouraging a specific economic activity or sector by granting it more credit facilities or limiting a certain activity by tightening the conditions for granting credit facilities. The credit monitoring here is qualitative on the facilities provided by banks (Hendi, 1999). The central bank exercises qualitative monitoring through several means (Shakir, 2015), including:

1. Determining an interest rate that varies depending on the type of credit facility. Banks commit to low-interest rates on credit facilities that the state encourages and tighten their credit policies regarding activities that are less important to society.
2. Setting different maturity dates for different credit facilities, with longer maturities for development loans.
3. Requiring central bank approval if credit facilities exceed a certain limit.
4. Determining different credit quotas for different economic activities, with higher credit quotas for agricultural or industrial activities and lower quotas for consumer credit (Article 29/1 of the Central Bank of Iraq Law).

These tools, whether quantitative or qualitative, are means for the central bank to monitor the credit policies of commercial banks. If the central bank wants to expand or tighten credit facilities in general or within a specific sector of the economy, it uses these tools to force banks to change their credit policies in line with the monetary policy desired by the central bank to achieve economic stability in the country.

Remedial means to reduce the failure of credit facilities

After presenting the preventive means that the bank follows to reduce the risks of credit facilities, we will show in this section the remedial means that the bank will resort to after

the occurrence of credit risks, and accordingly we will divide this section into two subsections, where we will address in the first subsection the insurance from credit risks, and we will devote the second subsection to Banking securitization and its role in risk reduction.

Insurance from the risks of credit facilities

Insurance against credit facilities risks is a factor in developing the relationship between the borrower and the lending bank. It is a legal mechanism that allows the bank to cover against the risk of default. Credit insurance is a risk management process that accompanies the credit facilities granted. According to the insurance contract, the insurance company guarantees the losses that may be incurred by the bank. The insurance company covers all losses that the lending bank may suffer and that are specified in the insurance contract (Ibtissem & Bouri, 2013). The insurance contract includes two main parties: the insurance company as an insurer and the insured, who is the creditor requesting coverage for credit facilities risks. The bank may ask its client to insure the risks that credit facilities may face in exchange for the client's commitment to pay the insurance premium (Al-Yassin & Irahim, 2017). The insurance policy aims to transfer the burden of risk to someone who can face this credit risk (See Article 37/Second of the instructions to facilitate the IBL), in exchange for a certain amount paid in advance to the specialized entity that carries these risks (Boumaraafi, 2013). It is worth noting that there are several forms of insurance against credit facilities risks, including:

Firstly, insurance on the credit amount

banks grant such insurance to their clients who need credit facilities. This requires a guarantee provided by the client to the bank to obtain the required funds (Al-Khudairi, 1987). The client may need to provide an insurance document to the bank to cover the risks of default that the bank may face. Through the insurance contract between the client and the insurance company, the bank obtains compensation corresponding to the insured risk, which is the client's failure to pay the debt owed to the bank (Boumaraafi, 2013). In such cases, the insurance company legally replaces the bank in lawsuits that may arise against clients who fail to pay. This type of insurance is equivalent to a guarantee because it provides similar benefits to those provided by a guarantee (Al-Yassin & Ibrahim, 2017). See Article 1001 of the Iraqi Civil Code, Article 972 of the Lebanese Code of Obligations and Contracts, and Article 771 of the Egyptian Civil Code.

Secondly, banks resort to requesting guarantees

when granting credit facilities to reduce the risks that may accompany the credit process (Amer, 1959). However, these guarantees may themselves be subject to risks that may decrease their value, such as fire or theft (Al-Yassin & Ibrahim, 2017). Therefore, banks try to reduce these risks by requesting that the client insure the guarantees in their favor, meaning that the bank is the beneficiary in case the risk is realized. On the other hand, banks may themselves enter into insurance contracts for their buildings and safes where they keep some of the guarantees provided by clients to protect themselves from losses that may affect those pledged funds (Abdel Aal, 2009).

Thirdly, credit life insurance

It refers to insuring the life of the borrower. The client insures their life for the benefit of the lending bank, which guarantees the repayment of the credit amount granted to the client in

case of their death and spares their relatives from having to repay the bank. The insurance company takes on the responsibility of repaying the credit facilities to the bank after the client's death (Hendi, 1999).

Debt securitization

Banks face significant risks when granting credit facilities that may expose them to the risk of bankruptcy. Therefore, banking legislation has sought to give banks more effective ways to reduce these risks through their credit policies. Securitization is one of the most prominent mechanisms that banks resort to in order to reduce the risks faced by the credit process. This is done by the lending bank converting non-liquid assets into liquid assets by consolidating debts and placing them in a single portfolio called a "securitization portfolio" and selling them to investors through a securitization company that issues bonds to investors in the securities market (Muhammad, 2018). Banking securitization is processed when the bank sells some of its secured assets at a low price, which are usually secured debt bonds with mortgage rights to a specialized facility that issues securities that are often issued at a premium and are equal in value to the debt being securitized and offered for public subscription to investors (Al-Sheikh, 2018).

The essence of the banking securitization process is that the bank consolidates similar debts in terms of purpose, term, and guarantees into a single securitization portfolio. Then, the bank turns to one of the credit rating agencies to evaluate and determine the extent of the book value's compatibility with the value at which it will be securitized. After that, the bank sells the securitization portfolio to a specialized company called a "securitization company," which only engages in issuing tradable bonds within the limits of the financial rights and receivables payable with the guarantees provided to it. The securitization company is not allowed to engage in any other activity besides issuing securitization bonds (Article 41 of the Egyptian Capital Market Law No. (95) of 1992).

Banking securitization involves the bank consolidating debts and placing them in a single portfolio called a "securitization portfolio" and selling them to investors through a securitization company that issues bonds to investors in the securities market (Qaloubi, 2011). The difference between the actual value of the securitization portfolio and the value at which it is purchased represents the return that the securitization company will receive. The securitization portfolio, with its guarantees, becomes the responsibility of the securitization company, enabling the bank to transfer credit risks outside its general budget by converting debts into cash (Muhammad, 2018). The securitization company is committed to protecting the rights of bondholders and maintaining their securities' value. The securitization company shall exercise the care of the prudent person in order to preserve the rights of the shareholders.

On the other hand, the Egyptian legislator has exempted banks from the obligation to maintain confidentiality of information without being bound by the confidentiality of accounts stipulated in the Central Bank and Banking System Law (Article 41/7 of the Egyptian Capital Market Law). The Iraqi legislator did not explicitly mention banking securitization, but this does not prevent banks from securitizing their debts. The IBL authorizes banks to engage in all non-prohibited activities, including securitization, and allows the Central Bank to issue instructions and regulations for conducting these activities (Article 27 / first / k of the IBL). Furthermore, Article 1 of the same law defines a financial instrument as "any debt security, tradable instrument, or any other instrument that is equivalent to a debt security, as well as any tradable instrument that grants the right to hold another tradable debt security through

subscription or exchange." From the above law, we can conclude that the Iraqi legislator has given the term "financial instrument" a broad definition that includes any tradable instrument, including securitized bonds, as a tradable debt security. Therefore, banks in Iraq are allowed to securitize their debts as long as their internal regulations permit it. However, it would have been better for the Iraqi legislator to follow the Egyptian legislator's example and explicitly allow for securitization and the establishment of specialized companies to carry out this process.

Conclusion

Results

1. Banks adopt several measures through their credit policies to reduce credit risks. These preventive measures include studying the creditworthiness of the client, monitoring the mechanism by which the credit amount is disbursed. On the other hand, there are remedial measures that banks resort to when risks occur, such as securitizing debts and insuring credit facilities against risks. The insurance company guarantees the losses that the bank may incur in case of associated credit risks.
2. The bank's credit decision is primarily based on the sound management of the bank's funds and confidence in the credit applicant. The credit decision depends on the information and data presented to the decision-making party, including an analysis and description of the client's position according to the credit study.
3. The credit process does not end with granting credit facilities to clients but extends to the usage stage. The legislation requires credit-granting entities and monetary authorities to monitor credit facilities granted to reduce defaults.

Recommendations

The Iraqi legislator is recommended to:

1. Amend the Central Bank Law to allow the Central Bank to license credit rating agencies, which would help banks make sound credit decisions.
2. Allow the Central Bank to establish expert houses that monitor and evaluate guarantees granted by clients as collateral for credit facilities.
3. Follow the example of comparable legislation and allows for the establishment of specialized companies to carry out securitization processes.

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2. The Egyptian Civil Law No. 131 of 1948.
3. The Iraqi Civil Law No. 40 of 1951.
4. The Jordanian Civil Law No. 43 of 1976.
5. The Egyptian Capital Market Law No. (95) of 1992.
6. The Egyptian Commercial Law No. (17) of 1999.
7. The Iraqi Central Bank Law No. 56 of 2004.
8. The UAE Credit Information Law No. (6) of 2010.
9. The Basic Decision related to the regulation of the relationship between banks and credit rating companies issued by the Central Bank of Lebanon No. 9641 of 2007.
10. The UAE Central Bank and Banking System Regulation Law No. 14 of 2018.
11. The Egyptian Central Bank and Banking System Law No. 194 of 2020.
12. The Instructions for Facilitating the Implementation of the Iraqi Banking Law No. 4 of 2010.