

# THE INSTITUTIONAL FRAMEWORK OF MACROPRUDENTIAL POLICY IN IRAQ: REALITY AND CHALLENGES

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## ABSTRACT

*The stability of the financial system is of great importance to the economic system as one of the main pillars of the development and progress of the national economy. The financial system conducts financial intermediation between savers and investors, thereby contributing to economic stability. Therefore, the Central Bank of Iraq is keen to surround the financial system by advanced control and supervisory system. This highlights the role of macroprudential policy, which focuses on the interdependence between financial institutions in the markets, and the extent to which these institutions are exposed to the risks arising from changes in macroeconomic performance and economic cycles. Thus, the objectives of the macroprudential policy are to maintain financial stability through the application of appropriate tools to address and contain financial imbalances, and to reduce the risk of crises across the financial system as a whole. Based on the institutional framework that enables this policy to achieve its objectives, which is represented by the Central Bank of Iraq.*

**Keywords:** Macroprudential policy, Financial stability, Institutional framework, Central Bank of Iraq.

## I. INTRODUCTION:

The global financial crisis in 2008 led to significant progress in the formulation and formalization of the macroprudential policy framework. The prevailing view before this crisis was that financial markets could only address possible imbalances and those market participants were able to avoid risks, but in fact, the financial system as a whole behaves differently from its individual components.

The importance of the macroprudential policy is clearly reflected in the activities of leading international organizations (such as Financial Stability Board, Bank for International Settlements, Basel Committee on Banking Supervision), which jointly develop the effective framework for the implementation of the macroprudential policy and the analysis and development

of tools to achieve macroprudential policy objectives to ensure a sound and safe financial system.

For example, the European Systemic Risk Board was established in 2010 to develop an effective macroprudential policy framework that would enable systemic risk prevention, mitigation and avoidance at the European Union level and enhance the financial system's ability to cope with sudden financial shocks by monitoring and assessment of systemic risk at normal times to prevent and mitigate any future disorder in the financial system can have serious negative consequences for both the financial system and the real economy. In November 2011, the European Systemic Risk Board issued a recommendation on the delegation to national authorities to implement macroprudential policy and strengthen their ability to identify key sources of

systemic risk and adopt measures to maintain financial stability.

Therefore, the implementation of macroprudential policy requires an institutional framework. An institutional framework of macroprudential policy based on strong legal grounds holds several advantages. The institutional framework gives appropriate authorities to the institution mandated with building the macroprudential policy. It also allows future policy decisions to carry weight and become binding. In addition, there will be a stronger accountability mechanism, which will motivate macroprudential policymakers to perform better and come up with intelligent decisions based on more solid evidence.

## II. THE CONCEPT OF MACROPRUDENTIAL POLICY:

### A. Definition of Macroprudential policy:

In view of the joint work of the Financial Stability Board, the Bank for International Settlements and the International Monetary Fund (IMF), the macroprudential policy is defined as the policy that uses a set of tools to reduce systemic risks, with a view to reducing the incidence of interruption in the provision of financial services Which have serious consequences for the real economy (FSB-IMF-BIS, 2011).The IMF also provides three specific elements in defining the macroprudential policy:

1. Objective: to minimize the impact of large-scale disturbances in the provision of financial services to the real economy.
2. Scope of analysis: through focusing on the financial system as a whole, including the interaction between the real sector and the financial sector.
3. Tools: the macroprudential policy mainly used as tools that are designed and calibrated to target systemic risk rather than the risk in individual institutions so that risks can develop even though individual institutions themselves appear safe and sound.

Park (2011) refers to the macroprudential policy known as the use of prudential tools to enhance the stability of the financial system as a whole and not necessarily of individual institutions within it only by mitigating the Pro-cyclical financial over time and making the financial system more resilient to

systemic risks arising from interdependence Based on the common exposures of financial institutions as a whole.

Suh (2012) argues that the macroprudential policy refers to a set of regulatory instruments primarily imposed on the process of financial intermediation for macroeconomic stabilization.

Goudard& Terra (2015) defines macroprudential policy as a set of rules governing the individual behavior of both individuals and financial institutions in the short term. The institutional nature of the organization process shows the paths that can be explored profitably, as well as the places the regulator wishes to prevent to get it. Accordingly, macroprudential policy can be defined as:

*"The policy of anti-cyclical of the financial system, which uses a set of tools to enhance the flexibility of the financial system and reduce systemic risks that make the financial system widely unable to continue to provide basic services of the financial intermediation whose interruption or disruption may have serious consequences for the entire real economy."*

Thus, macroprudential policy is not an end in itself, but rather a means of using a range of appropriate instruments aimed at providing a robust and robust financial system capable of coping with external shocks while performing its core functions of financial intermediation efficiently and effectively to promote sustainable economic growth.

### B. Importance of Macroprudential policy:

In recent decades, the global financial system has been characterized by liberalization and financial integration and accelerated technological development, which has made financial liberalization one of the main sources of systemic risk. Financial integration has widened the scope of crises, and technological progress and the spread of sophisticated financial products have spread Crises. A study of a sample of 21 countries showed that there was only one banking crisis during the period

1945-1970, while 19 crises occurred during the 30 years following that period, some of which occurred in individual countries and some spread to entire regional countries, All of which led to significant economic and social costs (Dumičić, 2015).

The 2008-2009 global financial crisis has highlighted that the talk of fiscal and monetary policies is no longer done in isolation from systemic risk reduction and counter-cyclical trends in the financial system. Financial stability is a precondition for a sound financial system that contributes to sustainable economic growth. While the objectives of monetary and fiscal policies, although clearly defined and accurate, are less clear in financial stability issues (Visco, 2011).

In addition, the global financial crisis has led to significant progress in the development and formalization of the macroprudential policy framework. The prevailing view is that financial markets can only address potential imbalances and those market participants are able to avoid risks, While the financial system as a whole behaves differently from its individual components (Dumičić, 2015).

The prevailing view before the global financial crisis of 2008 was that monetary policy should focus on its mandate to stabilize prices, not try to ease the financial cycle. This crisis also proved that monetary policy alone is not strong enough to restore price stability and economic stability quickly once they are disrupted by any financial crisis. Therefore, other policy tools are needed to reduce the likelihood and impact of these episodes. To this end, following the global financial crisis in 2008, the regulation and supervision of the financial system has been reformed worldwide. The introduction of macroprudential policy has been an important feature in the reform of the regulatory and supervisory framework of the financial system in the post-2008 global financial crisis (Damar&Molico, 2016).

C. *Objectives of Macroprudential policy:*

The objectives of the macroprudential policy are to reduce the risk of financial system failures and to avoid or reduce the costs of this hardship on the real economy (Krishnamurti& Lee, 2014). In other words, the macroprudential policy aims to strengthen

the financial system's ability to withstand shocks and reduce the accumulation of systemic risks in the financial system, balancing the need for efficiency and effectiveness of financial intermediation (Damar&Molico, 2016).

Caruana (2010) argues that the objective of the macroprudential policy is to reduce systemic risk by explicitly addressing the interdependence and joint exposure of all financial institutions and the trends of cyclical fluctuations in the financial system.

Here two objectives can be distinguished. The first objective is to strengthen the financial system's ability to cope with economic downturns and other adverse overall shocks. The second objective is to effectively reduce the accumulation of financial risks by putting pressure on the financial cycle to reduce the likelihood of financial failure. These objectives are not mutual, do not exclude each other. Both bypass the objective of microprudential policy in ensuring that individual companies have sufficient capital and liquidity to absorb adverse shocks. The macroprudential policy takes into account risk factors that go beyond the conditions of individual institutions to include the interplay between shocks and interactions that arise when individual institutions respond to shocks, Such factors determine the probability and consequences of systemic shocks that the macroprudential policy seeks to mitigate.

Thus, the fundamental and strategic objective of the macroprudential policy is to maintain the stability of the financial system as a whole so that it can perform its functions even in times of crisis, by strengthening the financial system's ability to withstand and reduce systemic risk, ensuring the sustainable contribution of the financial system to economic growth.

D. *Instruments of Macroprudential policy:*

Macroprudential policy tools can be grouped into three main groups that include credit, liquidity and capital. These three groups are as follows:

1. *Credit-related instruments:*

These tools are also called "borrower-dependent tools" or "real estate tools", which can target both borrowers and banks, ie, these tools target both the demand side and the supply side. The instruments that are linked to the supply side are targeted at

banks through the banks' balance sheet using instruments that affect risk weights such as determining risk weights for different ratios of loan to value and debt to income (as direct instruments) or through capital requirements (as indirect instruments). On the demand side, these instruments target borrowers and have a direct impact on loan terms and conditions (Šubáková, 2015), these tools include:

- a. Caps on the loan-to-value ratio: The caps on loan-to-value ratio limit the borrower's available funding to a certain portion of the asset's estimated value (usually residential property), which helps reduce credit demand and excludes risky borrowers (Fendoğlu, 2017). According to the International Monetary Fund, the application of limits on loan-to-value ratios should reduce the risk arising from strong credit growth and inflation of asset prices paid by credit (Lim et al., 2011).
- b. Caps on the debt-to-income ratio: Financial institutions study the amount of debt their clients can bear before they face financial difficulties. Thus, the caps on the debt-to-income ratio is used to restrict household indebtedness, i.e., to limit the total household debt to their monthly income, by imposing or encouraging a limit by the macroprudential authorities (Aizenman et al., 2017).
- c. Caps on foreign currency lending: Unrestricted lending in foreign currency is a major threat to financial stability. When a large portion of lending is denominated in foreign currency (or linked in some way to foreign exchange movements), sharp fluctuations in the exchange rate - especially low value - can have serious effects on the balance sheet for financial institutions with negative consequences on financial stability and the overall real economy (Dancourt, 2014). Therefore, Caps have been used to lend in foreign currency as a macroprudential measure to maintain the stability of the financial system.
- d. Caps on credit volume or credit growth: The caps on total bank lending or credit volume for a given sector are a ceiling is used to discourage the credit cycle and/or asset prices. A ceiling can

also be used for sector-specific credit (for example, the real estate sector) to contain a certain type of inflation in asset prices or to limit common exposure to specific risks (Lim et al., 2011).

## 2. *Liquidity-related instruments:*

The macroprudential policy instruments related to liquidity aim to mitigate liquidity risk, which is that there may be insufficient liquidity for operational requirements or to meet the financial institution's obligations on time. The most important macroprudential policy instruments associated with liquidity are as follows:

- a. Reserve requirements: Reserve requirements are the rules of central banks that require banks and other financial institutions to maintain a strict percentage of their deposits in the reserve with the central bank. Therefore, the use of reserve requirements can be highlighted as a macroprudential tool, in particular to enhance financial stability, by: (Barroso et al., 2017)
  - Reserve requirements can be a tool to countercyclical fluctuations and to manage the credit cycle on a broad scale.
  - This tool can also act as a buffer for liquidity in the downward trend of the cycle.
  - This tool can help contain the accumulation of systemic risks by improving the liquidity of the financial system.
  - Reserve requirements can target specific sectors to ease or restrict liquidity.
  - It can also be a complementary tool for capital requirements.
- b. Limits on net open currency positions: The limits on net open currency positions restrict the common exposure to foreign exchange risk in banks. In addition, these limits can be used to address sharp exchange rate fluctuations caused by the overlap of purchases and sales of foreign exchange by banks. Maximum limits are set for the open position for each foreign currency as a percentage of the Bank's capital and reserves (Lee et al., 2015).
- c. Limits on maturity mismatch: The financial institutions' regulation of maturity of assets and liabilities can give details of the liquidity of their

financial position. Limitations on the mismatch of maturities are therefore used as a macroprudential tool to address systemic risks because the conversion of maturities involves clear risks and is a source of financial vulnerability and negative external factors (Landau, 2016).

- d. Loan-To-Deposit Ratio: Restrictions on the ratio of loan-to-deposit are to strengthen the liquidity position of banks, to ensure that banks are always able to meet their short-term liabilities, and to reduce the tendency of banks to keep pace with procyclicality (Satria et al., 2016).

### 3. *Capital-related instruments:*

Capital-related Macroprudential policy instruments require that financial institutions maintain high-quality capital capable of absorbing losses due to different risks. The main objective of the use of capital instruments is to strengthen the resilience of these institutions and the resilience of the financial system as a whole. Moreover, higher capital would reduce the likelihood of banks failing and the impact of a particular bank failing on other parts of the financial system and thus on the economy (Grace et al., 2015). The most important macroprudential tools related to capital are as follows:

- a. Countercyclical capital requirements: This tool sets periodically buffer on the minimum for bank capital requirements. Banks will need to maintain an additional temporary capital buffer when credit growth in the private sector is excessive and stimulates system-wide accumulation of risks during the boom of cycle (South African Reserve Bank, 2016).
- b. Dynamic provisioning: Dynamic provisioning is clear that these provisions mean building a reserve in good times and then using it to cover losses when they appear in bad times (Wezel et al., 2012). Dynamic provisions, therefore, help break or avoid the effect of cyclical trends in the financial system by creating temporary countercyclical provisions.
- c. Restrictions on profit distribution: This type of restriction usually results in the addition of retained earnings to capital. Thus, as a result of this enhanced capital structure, banks can deal

with periods of recessions without injecting additional capital (Ansari, 2018).

- d. Sectoral capital requirements: The fact that banks are required to increase capital against exposure to a specific sector also sends a strong signal to banks and market participants about the risks of lending to this sector. Banks are expected to review their credit practices and pricing policies in the sector, which may see some tightening of credit conditions, leading to a flow of expectations that credit growth will slow to asset price expectations, helping to ease demand for speculative purposes (Reserve Bank of New Zealand, 2013).
- e. Leverage Ratio: A leverage ratio would reduce the accumulation of systemic risk by reducing the effects of risk weight pressure during the boom period. Therefore, the leverage ratio is expected to behave counter-cyclically, being tighter in the duration of boom and more flexible in the duration of deflation. Therefore, if the bank's capital behaves this way during the cycle, the probability of a crisis will decrease (Gambacorta&Karmakar, 2016).

### III. MACROPRUDENTIAL POLICY IN IRAQ:

#### A. The institutional framework of Macroprudential Policy:

The first step consists in institutionalizing the macroprudential policy in defining the institutional and legal framework under which this policy operates. The Central Bank of Iraq (CBI) carries out the duties of applying the macroprudential policy to the institutions of the financial system in Iraq, the fact that the CBI is the supervisory authority over banks and other financial institutions. This task has been entrusted to the Banking Monitoring Directorate, which is one of the main and central departments in the Central Bank of Iraq. This Directorate will monitor the compliance of banks and other financial institutions with the requirements of prudential instruments and standards that ensure that banks' financial conditions are consistent with international standards (Abdul-Nabi, 2010).

This Directorate also deals with credit granting transactions and calculating liquidity ratios. It also provides licenses for practicing banking and remittance, as well as proposing amendments to the laws, regulations and instructions that govern and regulate financial and banking activities and enhance monitoring through analysis and evaluation of periodic performance. This Directorate consists of five sections and two divisions, the work of each of which is as follows: (Banking Monitoring Directorate, 2013)

1. Department of commercial banks monitoring: It works to register and license banks, perform office and field audits, develop a set of international controls and standards to regulate and control the work of banks, and strengthen monitoring by analyzing and evaluating periodic performance.
2. Department of Islamic Banking Monitoring: This department registers, licenses banks, conducts office and field audits, develops a set of international standards for monitoring banks, and how to comply with them, compliance with Shari'a supervision requirements, development of a mechanism for preparing instructions and formulate regulations governing the work of Islamic banks, and strengthen monitoring by analyzing and evaluating periodic performance.
3. Department of Credit Information and Public Protection: This department includes credit registry operations, customer and beneficiary affairs, banking awareness and outreach to civil society organizations.
4. Department of supervision of non-bank financial institutions: The functions of this department are to register and license companies, conduct office and field audits, develop a set of international standards to monitor these companies, how to comply with them, develop a mechanism to prepare instructions and formulate controls governing the work of companies.
5. Department of Banking Performance Analysis and Risk Monitoring: This department analyzes the performance of banks through the audit of financial statements and the assessment of risks to which they are exposed.
6. Section of Review of Foreign Currency Selling and Buying Operations: This Section performs the function of monitoring the banks in terms of their compliance with instructions to sell foreign currency whether through the window of sale and purchase of foreign currency remittances and appropriations.
7. Section of IT Audit in Banks and Companies: It monitors the electronic systems of banks and financial companies of this department, examines the reports submitted by the international auditing companies (external auditor), contracting with the banks, and supervising the audit of ICTs and managing their risks.

B. The legal framework under which Macroprudential policy operates:

The CBI, in its mandate to implement the macroprudential policy, relies on the Central Bank of Iraq Law No. (56) of 2004 and the Banking Law No. (94) of 2004 and the instructions issued in 2011 that clarify the Banking Law.

These two laws give the Central Bank of Iraq the right to take the necessary measures required by the nature of work financial and banking system and the developments and changes. In other words, it allowed the Central Bank to deal with the most detailed financial and banking aspects by authorizing it to issue the regulations and instructions to facilitate the implementation of the provisions of these laws, and in light of the principles, limitations and rules therein, which aim at ensuring safe and sound banking work and stability of the financial system (Official Gazette of Iraq).

However, we note that there is no law or a decision on the macroprudential policy of the Central Bank of Iraq to stabilize the financial system, but rely on the provisions of the laws in force to implement the tools of the macroprudential policy.

This is where the most important challenges arise. One institution that works to implement more than one policy represents a major challenge in achieving the objectives of each policy (Monetary policy and Macroprudential policy). Consequently, this leads to an overlap of work and decisions on the selection and application of tools to deal with fluctuations or crises in the financial system.

Which in turn makes it difficult to determine the effects of each policy to the extent that it is difficult to determine the interaction between the effects of those policies. Which could lead to undesirable results affecting the financial intermediation process in the financial system.

#### IV. CONCLUSION:

Macroprudential policy is an important and necessary policy to enhance the stability of the financial system. The macroprudential policy is effective and efficient in achieving its objective when it operates within an institutional framework and a legal framework capable of implementing the tools of this policy and developing these instruments, taking into account the nature and circumstances of the financial system.

In Iraq, the macroprudential policy is implemented by the Central Bank of Iraq, which is the economic institution with the authority to apply supervision and control over the integrity of the Iraqi financial system. The Central Bank of Iraq depends on each of the Central Bank of Iraq Law No. (56) of 2004 and the Banking Law No. (94) of 2004 in the implementation of the macroprudential policy to reach a secure and stable financial system.

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