The Role of Banking Compliance to Reduce Risks to Run

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ABSTRACT

The importance of operational risks increases with the increase in technological development, the development of banking operations, the extent of banking compliance, and the attempt of many banks to achieve quality in banking services. And the extent of the position occupied by Iraqi banks for banking compliance and reducing operational risks. The Basel Committee (2) paid its attention to operational risks and the interest of international banks to follow policies that work to ensure banking compliance and cover operational risks, because of its role in reducing losses due to increased costs and achieving an increase in profits. Realizing and working to confront the best possible and traditional methods, that some risks Operational problems may cost banks huge losses resulting from non-compliance with the regulations and laws issued by the Central Bank. There are also challenges facing banks in light of the growing operational risks. The research hypothesis is that banking compliance has an effective and positive role in reducing operational risks, which are represented by technological, strategic, environmental, and political risks, and administrative and financial corruption. The research aims to: determine the extent of operational risks, identify their procedures, and confront those procedures in banks through banking compliance. Determine the relationship of operational risks to banks' performance, determine the size and scope of Chilean risks, and the mechanism for calculating capital in accordance with the decisions of the Basel Committee (2). It also shed light on the decisions of the Basel Committee and revealed the dusty effects on their application in financial institutions. The research came out with several conclusions and recommendations, the most important of which is that most banks use a method to evaluate operational risks in a theoretical manner, and it lacks the practical aspect and lack of procedures to reduce them. Operational risks affect the profitability and reputation of banks and the large number of losses they bear. Therefore, advanced methods are used to measure banking operational risks for the purpose of managing these risks and evaluating capital adequacy after obtaining the approval of the Central Bank of Iraq. It pays attention to providing an amount of cash in banks and additional balances such as gold coins and foreign currencies for the purpose of meeting its financial obligations.

Keywords : *operational risks; banking compliance; banking system*

INTRODUCTION

The Basel Committee (2) paid its attention to operational risks and the interest of international banks to follow policies that work to ensure banking compliance and cover operational risks, because of its role in reducing losses due to increased costs and achieving an increase in profits. Realizing and working to confront the best possible and traditional methods. As a result of technological development and the development of the surrounding banking environment, operational risks that have hindered the work of commercial banks have evolved, such as weak electronic systems and the widening levels of fraud and professional errors in banks. Which leads to an impact on the reputation of banks and their competitive position with other banks, as well as increasing the possibility of banks collapsing and exposing them to major losses.

RESEARCH IMPORTANCE

The importance of operational risks increases with the increase in technological development, the development of banking operations, the extent of banking compliance, and the attempt of many banks to achieve quality in banking

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services. And the extent of the position occupied by Iraqi banks for banking compliance and reducing operational risks.

Research Problem

Some operational risks may cost banks huge losses resulting from non-compliance with the regulations and laws issued by the Central Bank. There are also challenges facing banks in light of the growing operational risks.

Research Hypothesis

The research hypothesis is based on :

(Banking compliance has an effective and positive role in reducing operational risks, which are represented by technological, strategic, environmental, and political risks, and administrative and financial corruption.)

Research Objective

The research aims to :

1- Determine the extent of operational risks, identify their procedures, and confront those procedures in banks through banking compliance.

2- Determine the relationship of operational risks to banks' performance, determine the size and scope of Chilean risks, and the mechanism for calculating capital in accordance with the decisions of the Basel Committee (2).

3- Shedding light on the decisions of the Basel Committee and showing the dusty effects on their application in financial institutions.

FIRST TOPIC: THEORETICAL FRAMEWORK FOR BANKING COMPLIANCE AND OPERATIONAL RISKS

First : The Concept Of Banking Compliance

The banking sector faces various risks, which are inherently linked to the nature of the environment in which it operates. This environment encompasses diverse commercial and investment activities characterized by speed, credit, and high financial liquidity. Therefore, banks are obligated to strictly adhere to legal regulations to avoid any potential risks that may arise. Banking compliance is defined as a distinct function within the banking industry and serves as a crucial response to non-compliance with legal rules or any violation of instructions and regulations in any form.

Banking compliance entails strict adherence to both the letter and spirit of the law, regulations, and instructions. It represents the highest level of commitment beyond ordinary compliance. It also involves respecting the application of the law, instructions, regulatory requirements, and ethical standards in banking operations. This applies to all bank employees, from top management to lower-level staff, at all levels of the organization.

In the banking sector, compliance is essential to mitigate risks arising from the complex and dynamic business and investment environment. It ensures that banks operate within the boundaries of the law, maintain the highest ethical standards, and fulfill regulatory requirements.

It is evident that banks must respect the laws in their entirety, and that banking activities are closely tied to legal regulations. Central banks and various international bodies concerned with banking issue regulations, instructions, and specific rules intended for application by local banks or for mandatory compliance at the national level. This falls under the umbrella of compliance with all legal directives, especially international regulations when adopted by the national central bank. Therefore, all banks are obligated to respect and apply the law to all their banking transactions, both at the domestic and international levels.

Banking compliance is generally observed in the banking sector, whether in traditional banks or Islamic banks. In the case of Islamic banks, compliance takes on a unique and suitable legal form that aligns with the nature of Islamic banking operations. Banking compliance is built on providing advice, guidance, monitoring, and reporting.

This adherence to legal and regulatory requirements ensures that banks operate within the framework of the law and maintain ethical standards.

Compliance is practiced through the verification and assurance of the Central Bank's commitment across all departments and entities to adhere to compliance standards and requirements. This is particularly crucial in areas such as financial disclosure, anti-money laundering, adherence to banking agreements, and international accounting standards. It also involves the development and reengineering of procedures and mechanisms, proposing work instructions for financial and banking institutions, especially in the principles of disclosure and the identification of the source of funds within the banking system.

Moreover, it includes collaboration and coordination with the Risk Management Department to identify the most significant internal and external risks that may result from non-compliance with the central bank's monetary policy and international compliance standards. Furthermore, it entails providing the necessary advice, consultations, and proposing instructions to execute the vision and mission of the central bank in enhancing its performance based on best practices, efficiency, transparency, and excellence.

It is essential to diagnose the training programs related to recovery standards, identify the skills and competence of employees, and extend the compliance policy to all employees in the central bank, banking institutions, and non-banking financial institutions.

Compliance is the act of applying rules, laws, and regulations, and it applies to legal and regulatory requirements set by industry authorities, as well as internal company policies. In the GRC (Governance, Risk, and Compliance) model, compliance includes implementing procedures to ensure that business activities conform to relevant regulations. These are commonly referred to as compliance risks or non-compliance risks, which are multiple risks that companies may face if they fail to adhere to established laws and regulations. These risks are related to the company's reputation, financial penalties, and other legal consequences.

Second : The Concept Of Operational Risks And Their Types

Operational risks are among the significant challenges faced by banks in general, and these risks can lead to significant losses for these banks. Operational risks encompass the issues arising from the day-to-day operations of banks, including risks caused by human errors, professional errors, technological failures, and the systems used. These risks can also result from internal incidents within the bank. Legal risks are also considered part of operational risks, as the Basel Committee on Banking Supervision has included them as a component of operational risks.

The framework for managing operational risk includes an operational risk management policy adopted by the central bank's board of directors, as well as various procedures and tools used to identify all operational risks that may result from inefficiency or failure in internal procedures, individuals, or electronic systems used within the bank. Therefore, operational risks are the risks that arise from the inadequacy or failure of internal and external operations, individuals, or technological systems. These risks include the absence of fully documented processes or their regular updating, staff shortages, or the lack of necessary skills to address various challenges, increasing reliance on software and systems, and external events such as natural disasters and political changes.

Operational risks for banks refer to the risks of exposure to losses resulting from inadequate or diminished internal operations or systems due to external operations.

The risk of changes in value resulting from actual losses due to insufficient internal or external operations, including legal risks, can lead to actual losses. The Basel Committee on Banking Supervision has defined operational risks as "the risk of loss resulting from inadequate or failed internal processes, or from external events." This definition includes legal risks but excludes strategic and reputation risks. Basel allows banks to adopt their own definitions of operational risks for their internal purposes, provided that the minimum elements in the committee's definition are included.

Operational risks can be divided into:

1- Technological risks: These are the result of misuse of modern technologies and malfunctions in computer systems and programs, as well as automated teller machine systems, home banking, and money transfer systems. (Cristina & Florentine, 2005 : 154). Theft of data, information and money may result.

2- Legal risks: The bank may be exposed to documentary gaps that make them legally unacceptable, as well as risks resulting from non-mandatory implementation of contracts. (Hashad, 2005 : 42) Legal risks can be divided into laws and regulations such as the Egyptian Bank Law, instructions issued by the regulatory authority represented by the central bank, decisions from higher authorities, and banking non-compliance with them.

3- The risks of administrative and financial corruption: It may result from wasting money, loss, and harm to the bank, shareholders, depositors, and members of society. (Al-Shorabi, 2007 : 226) Its forms include bribery, embezzlement, and forgery.

4- Environmental risks: The risks resulting from and surrounding banks that affect the performance of banks and may lead to their cessation, such as floods, fires and terrorism. (Hanafi, 2002 : 173).

5- Strategic risks: These are the result of management's inability to make decisions that lead to achieving gains for banks or avoiding the risks they are exposed to. It may lead to bankruptcy. (Koreszner, 2008 : 11).

Operational risks are financial losses or damages that arise from insufficient or failed internal processes, employees, group systems, or other external factors. Operational risk management is conducted through internal work procedures and monitoring mechanisms. Legal risks are managed through effective consultation with legal advisors, both internal and external to the group. Other types of operational risks are managed through ensuring the availability of trained and qualified staff, suitable infrastructure, control mechanisms, and effective systems for diagnosing, assessing, and managing all inherent risks.

The group is also exposed to risks related to its responsibilities regarding trust and custody of deposited funds. Trust and custody risks stem from the failure to perform in accordance with the explicit and implicit standards applicable to the custodial responsibilities in Islamic banks, leading to losses in investments or failure to protect the interests of investment account holders. Subsidiary units of the group have appropriate mechanisms to safeguard the interests of all depositors.

In cases where funds from investment account holders are mixed with the group's own funds in a unit of the group, the concerned group unit verifies the establishment and application of principles for the allocation and sharing of assets, revenues, costs, and profits in a manner consistent with the group's custodial responsibilities. Subsidiary units of the group bear primary responsibility for identifying and managing their operational risks. Policies and internal control procedures require a separation of duties, delegation of authority, preparation of reports on violations and exceptions, and reconciliation of accounts, all based on periodic and reliable management reports.

Separate and independent internal control units continuously monitor daily business procedures and ensure compliance with basic control procedures. The expansion of banking activities, the development of the technologies used in them, and the discovered and potential human errors have led to the emergence of a new type of risk, which is operational risk, which requires banks to manage it by following a path that ensures that risks are defined, measured, and followed up in order to reduce their frequency and financial impact (loss), and then confront them. The Basel II Committee gave banks three methods of measurement: (Abu Kamal, 2007 : 50).

1- The basic indicator method: which urges banks to maintain operational risk capital equal to a fixed percentage of the average total income during the previous three years.

2 - The standard method: It stipulates that banks divide their activities into eight standard business lines, defined by the Basel II Committee, and then calculate the raw annual output of the corresponding business line multiplied by a fixed factor ranging between (12 and 18%). Depending on the line of business in question.

3- Advanced measurement method: which is based on dividing the bank's activities into business lines, and the losses resulting from each activity or business line as a result of operational risks are monitored, so that those risks can be reduced to the greatest possible degree.

As for monitoring operational risks, it is carried out through internal and external methods with the aim of controlling and reducing the recurrence of incidents causing operational risks and their impact if they occur, while internal methods are represented by activity continuity plans that aim to ensure the provision of services to the bank when incidents occur that may threaten its activity, while external methods are used to control operational risks. Such as insurance contracts, banks are required to allocate a portion of their capital to cover operational risks as a guarantee for the rights of depositors, and this is within the framework of the solvency ratio called "McDonough," which was introduced by the Basel Accords. (Natiq, 2022 : 2).

Third : The Concept Of Operational Banking Risks And Their Development

The Basel Committee defined operational banking risk as the risk of loss resulting from inadequacy or failure of internal processes, personnel, or systems, or due to external events. (Basel Committee, 2003: 2) It also means that it is the risk that arises from changes in operating expenses that are different from what is expected. Which leads to a decrease in net income and the value of the bank. (Ghoneim, 2005:82). The banking environment in the seventies of the last century was characterized by stability, which resulted from the combination of several factors, including intense competition and legal regulation of banking business through the banking model (Hammad, 2003: 190). As for the eighties, it witnessed a kind of cautious change in the activities and services it provided, such as marketing, project financing, and business cards. Credit and financial derivatives. The share of competition within the market also intensified, which led to the emergence of banking risks, the transition from commercial banking services to capital markets, and increased volatility. (Belazuz, 2013: 33). The rapid development of banking services, the increase in technology and electronic banking services, as well as the increased dependence of banks on external parties to provide services, which has led to an increase in operational risks.

As for the sources of operational risks, they include (Abu Salah, 2007 : 32) :

1. Risks arising from errors in manual data processing and risks related to computer system failures, as well as the use of automated and technological systems in executing banking operations.

2. Risks of external fraud and cases of computer breaches.

3. Risks arising from the merger of major banking institutions. Banks' adoption of various means to reduce exposure to credit and market risks through collateral or financial derivatives.

SECOND TOPIC: THE BANKING SYSTEM AND ENHANCING COMPETITIVENESS IN IRAQ

First: The Structure Of The Banking System In Iraq

The banking system means a group of entities that attract funds from individuals or companies and redirect them to agents according to an organized mechanism determined by the monetary authorities. It consists of banks, various banking products, and the central bank, which represents the monetary authority. These entities form what is known as the pyramid of the banking system, which is the basic pillar of the macroeconomy and its development in any country. The banking system in Iraq has expanded without developing banking services or integrating the monetary policy that regulates the work of these banks. Iraq ranked first among the Arab and international banking systems in numerical terms, with (81) banks, including (7) government banks and (74) private banks, including (25) commercial banks, and (29) Islamic banks, in addition to (21).) A branch of a foreign bank. This number is considered the highest in the world compared to some countries in the region, as the number of banks in Turkey (43), Egypt (41), Saudi Arabia (31), Iran (30), Jordan (26), Algeria 20, and Britain (54) banks. Report of the Central Bank of Iraq, 2022: 18. As shown in Table No. (1) :

Table (1) Number of government and private banks in Iraq 2023

Number of banks	Bank type	No
7	**Government bank**	**1**
25	**Commercial bank**	**2**
29	**Islamic bank**	**3**
81	**total**	**4**

Source : Table prepared by the researcher based on data from the Central Bank of Iraq.

Despite the large number of banks in Iraq, they have not played a suitable financial role nor provided modern banking activities and services capable of implementing monetary policies and controlling the money supply for economic and developmental financing.

Central Bank data indicates that the money supply outside the banking system exceeds 84 trillion dinars out of a total money supply estimated at 87 trillion dinars. This confirms the weakness of the Iraqi banking system in mobilizing these massive funds and preventing cash leakage, representing a significant portion of the printed money held by citizens outside the banking system. The process of openness after 2003, which led to the spread of administrative and financial corruption, increased unemployment rates, poverty, and weakened financial inclusion indicators, coupled with citizens' lack of trust in banks, all significantly contributed to the exacerbation of the phenomenon of cash leakage outside the banking sector.

Second : Banking Compliance In Light Of Commercial Banking Activity

Commercial banking activities regulated by the monetary authority indicate that the interest rates imposed by banks on loans granted to citizens are the highest in the region, exceeding 6% with cumulative interest. This means that citizens pay an additional interest rate of up to half of the borrowed amount, while lower interest rates of 2-3% are paid for deposited amounts. This reflects the weakness of monetary policy and the commercial banking sector's focus on maximizing profits from non-banking activities, particularly trading in the US dollar after purchasing it through the Central Bank of Iraq's currency window.

Financial access in Iraq ranks among the lowest in the world, with only 19% of adults holding a bank account, indicating a significant untapped source of financing. The lack of funding represents the most significant constraints faced by small and medium-sized enterprises and companies operating in the informal sector, hampering private sector-led growth. This is attributed to the structure and operations of the banking sector, which do not keep pace with global economic developments. Urgently modernizing the banking system's infrastructure, currently a major obstacle to economic diversification, is a critical requirement for boosting the private sector and creating employment opportunities. (World Bank, 2023: 23)

The Iraqi banking system exhibits weaknesses, with certain private banks concentrating on activities like money laundering and currency smuggling, contributing to financial corruption within the Iraqi economy. This characteristic has been associated with the banking system as a whole and, in particular, with private banks since the Central Bank initiated the sale of dollars to these banks through what is known as the currency window. As a result, these banks have generated substantial profits that cannot be achieved through traditional banking operations, diverting their focus from developing their banking activities and services. Consequently, in 2023, the U.S. Department of the Treasury and the U.S. Federal Reserve imposed sanctions on 14 private banks following revelations of their involvement in money laundering and currency smuggling since 2022.

These sanctions represent an effort to regulate and enhance the Central Bank and Iraqi banks' international compliance with regulations related to money laundering and the fight against terrorist financing. The goal is to ensure adherence to specific laws, international systems, codes of conduct, standards, and best practices and their integration with the global economy. Additionally, there is an emphasis on safeguarding Iraq's resources from illicit smuggling and money laundering while promoting the digital economy through the Central Bank.

The Central Bank faces a significant task in establishing a banking system that adheres to international standards, demonstrates financial integrity, and actively contributes to the economy by mobilizing savings and financing development, moving away from currency trading and the allegations of smuggling, money laundering, and banking misconduct. In a regulatory and binding step for international and domestic compliance, the Central Bank has instructed authorized banks to increase their capital. This includes raising banks' capital to no less than 400 billion Iraqi dinars by the end of December 31, 2024, in three installments, with each installment being no less than 50 billion Iraqi dinars. Banks are required to increase the operating capital for foreign bank branches to no less than 60% of their operating capital by the end of 2023. Failure to adhere to these instructions may lead to mergers, acquisitions, or liquidation.

This step is essential to cleanse the banking sector of weak institutions, avoid financial difficulties or liquidation, and focus their activities on legitimate banking operations while enabling them to finance the economy and its various sectors. Mergers will strengthen banks' capital, which plays a crucial role in maintaining the safety, soundness, and overall integrity of banking systems. Capital serves as a barrier or safeguard preventing any unexpected losses that could impact depositors' funds. Banks, in general, operate in an environment characterized by a high degree of uncertainty, exposing them to various risks. Since authorized private banks cannot achieve this compliance individually due to the required capital size, they will be forced to merge. Through this consolidation, we will have a purified banking system with a manageable number of banks boasting substantial capital and high competitiveness. The benefits of this consolidation include harnessing economies of scale and other advantages realized through banking mergers and acquisitions. Commercial banks will be able to efficiently conduct their banking operations, and Islamic banks will promote Islamic banking transactions and introduce new banking products to effectively mobilize deposits and finance the economy.

Banking mergers and acquisitions have been practiced since the 1980s with the aim of growth, expansion, and enhancing the competitive capacity of banks. This trend has also been justified in light of other facilitating factors such as the digital economy, the shift towards sustainable financing, profitability challenges, asset quality issues, regulatory intervention, and economic variables that have emerged following the global economic downturn caused by the COVID-19 pandemic.

Third : The basic pillars of the Basel Committee (2) for banking operational risks

1- Improvement in the quality of the capital base: Banks must increase the capital that constitutes reserves of shares and profits by about 4.5% and allocate an amount for crises of about 2.5%. The committee also stipulated for major banks to increase the percentage to 7%, and adding the reserve may reach 10% of that. It gives banks additional resources to meet the requirements and challenges of operational risks. Table No. (2) shows the banks' capital adjustments program.

Table (2) Capital adjustments according to Basel (2) Percentage%

2016	2015	2014	2013	
4.5	4.5	4.0	3.5	Minimum capital ratio of shareholders' equity
5.1	4.5	4.0	3.5	Minimum capital ratio of shareholders' equity plus hedge capital
6.0	6.0	5.5	4.5	The minimum capital is Tier 1
8.0	8.0	8.0	8.0	Minimum total capital
8.6	8.0	8.0	8.0	Minimum total capital plus hedging capital

Source: Basel Convention (2) 2010

1- Liquidity and adoption of the financial well-being index: Banks are in urgent need of sufficient liquidity to meet monetary financial obligations in addition to financing investment requirements in treasury bills and government bonds. It may be short-term or long-term.

Operational risks negatively affect the performance of banks, so there should be sufficient capital to address operational risks. Banks should also be developed to monitor and control risks and instill a culture of awareness of risks and appropriate mechanisms for identifying them.

CONCLUSIONS

1- Weak awareness among employees of the nature of operational risks through various types of risks due to the lack of follow-up of banking developments, issuances and periodicals and the lack of experience and courses held for employees in banks.

2- Not establishing independent units within banks to manage, determine, measure and hedge risks.

3- Most banks use a method to evaluate operational risks in theory, but it lacks the practical side and there are no procedures to reduce them.

4- There are shortcomings and weaknesses in the strategies of banks' boards of directors to manage operational risks in those banks and low interest in the reports that must be submitted to the banks' senior management.

5- Operational risks affect the profitability and reputation of banks, and the large number of losses they bear are the result of operational failure, and the implementation of activities is only achieved by activating the role of internal control.

6- There is an inverse relationship between operational risks and the performance of banks related to weak management, lack of experience, or lack of training. The lower the risks, the higher the banks' performance.

RECOMMENDATIONS

1- Organizing development courses by banks to include the practical aspect of operational risks, identifying fraudulent operations, and seeking the assistance of expertise and specialists in banking risk management.

2- Legislation to amend the instructions of the Central Bank of Iraq regarding the mechanism for calculating the capital adequacy standard in Iraqi banks to indicate the extent of control and determine the minimum limit for capital adequacy in accordance with the mechanisms of the Basel Committee (2).

3- Preparing emergency plans to confront potential problems and challenges and reviewing those plans periodically to ensure their suitability and the needs of the banks.

4- The necessity of supervisory review and disclosure, and the necessity of adhering to the application of international standards in the field of capital adequacy, followed by evaluating the efficiency of its review tools.

5- Using advanced methods to measure banking operational risks for the purpose of managing these risks and evaluating capital adequacy after obtaining the approval of the Central Bank of Iraq.

6- Paying attention to providing an amount of cash in banks and additional balances such as gold coins and foreign currencies for the purpose of meeting its financial obligations.

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