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Measuring the Impact of Credit Policy on the Financial Performance of the Banking Sector in Iraq

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Abstract. The study aimed to analyze the impact of credit policies on the financial performance of the banking sector in Iraq using the ARDL Model, based on time-series data covering the period (2003–2025). Return on Assets (ROA) was adopted as an indicator of financial performance, while the credit policy variables included total credit (CRE), net interest margin (NIM), non-performing loans (NPL), and loan loss provisions (LLP). The results revealed the existence of a long-run equilibrium relationship among the study variables, along with a positive and statistically significant effect of total credit on financial performance, with a coefficient value of (0.816), reflecting the importance of expanding lending activity in enhancing banking profitability. In contrast, the effect of the net interest margin was positive, with a coefficient value of (0.260), but statistically insignificant, indicating the limited role of the interest rate channel in the Iraqi economy. The findings also showed a negative and statistically significant effect of both non-performing loans (-3.181) and loan loss provisions (-0.507) on return on assets, reflecting the adverse impact of rising credit risk and deteriorating asset quality on bank profitability. The study emphasizes the importance of adopting sound credit policies that strengthen risk management and asset quality in order to support financial stability and improve the efficiency of the banking sector in Iraq.

Keywords: Credit Policies, Financial Performance, Return on Assets, Non-Performing Loans, Banking Sector.

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Introduction

Credit policies are considered one of the fundamental pillars of banking operations, given their pivotal role in directing financial resources toward various economic activities and in achieving a balance between profit maximization and risk mitigation (Tahu et al., 2025). These policies acquire particular importance in rentier economies, such as the Iraqi economy, where the banking environment is characterized by limited productive diversification and a heavy reliance on oil revenues, alongside underdeveloped financial markets and a high degree of uncertainty. In this context, the design and implementation of effective credit policies become a crucial instrument for enhancing the efficiency of financial intermediation and supporting financial stability.

Despite the developments witnessed in the Iraqi banking sector in recent years particularly in terms of banking reforms and strengthened regulatory frameworks it still faces several challenges, including high levels of non-performing loans, weak risk management practices, and the modest role of credit extended to the private sector in stimulating economic activity. Moreover, the effectiveness of

traditional monetary policy channels, especially the interest rate channel, remains relatively limited due to the dominance of a cash-based economy and the shallow depth of the financial sector. This raises a fundamental question regarding the extent to which credit policies are effective in improving banks' financial performance, as well as the nature of this impact in both the short and long run.

Applied literature indicates that the efficiency of credit management particularly in terms of allocation quality and risk monitoring is closely associated with financial performance indicators such as profitability, asset quality, and liquidity (Kato et al., 2024). Weak credit policies tend to increase non-performing loans and deteriorate the quality of the credit portfolio, which negatively affects banks' stability and the sustainability of their performance. In contrast, the adoption of sound credit policies contributes to improving the efficient use of financial resources and enhances banks' ability to withstand economic shocks (Isanzu, 2017; Kwashie et al., 2022).

Accordingly, this study aims to analyze and measure the impact of credit policies on the financial performance of the banking sector in Iraq using a modern econometric framework. This approach facilitates a deeper understanding of the relationship between credit-related variables and financial performance indicators, and provides empirical evidence that can support the development of banking policies and enhance the efficiency of the financial sector.

The importance of this study stems from its attempt to provide a contemporary econometric analysis of the relationship between credit policies and financial performance in the Iraqi banking sector, particularly following the implementation of Basel II requirements, within an economic environment characterized by distinct structural features. In addition, the study contributes to addressing a research gap related to the scarcity of recent applied studies in this field and offers empirical evidence that can assist policymakers in improving credit management and strengthening financial performance and stability.

1. Literature Review:

1-1. Theoretical Review

Credit policies constitute one of the core components of commercial banking operations, as they represent the mechanism through which financial resources are allocated across different economic sectors in a manner that balances return and risk. Their importance stems from the fact that lending is the primary activity of banks; therefore, the efficiency of designing and implementing credit policies is directly reflected in asset quality, profitability levels, and financial stability. In this context, credit policies are defined as the set of rules and procedures governing the process of loan granting, determining its terms, monitoring mechanisms, and managing the associated risks (Greenbaum et al., 2019).

The theoretical analysis of the relationship between credit policies and financial performance is grounded in several conceptual frameworks. First, the theory of financial intermediation posits that banks play a vital role in transforming savings into investments by reducing transaction costs and information asymmetry problems, making credit efficiency a key determinant of financial performance (Mishkin, 2016). Second, the theory of information asymmetry highlights the risks of adverse selection and moral hazard in lending activities, which necessitates well-designed credit policies based on effective credit evaluation and continuous monitoring to reduce non-performing loans (Akerlof, 1970). Additionally, the theory of bank risk management emphasizes that sustainable profitability depends on a bank's ability to manage risks particularly credit risk through diversification, setting credit limits, and employing modern measurement tools (Jorion, 2019).

From another perspective, the relationship between credit policies and financial performance can be interpreted through the risk–return trade-off theory. Expanding lending may enhance profitability in the short run, but it can also increase risk if credit standards are weak (Sharpe, 1964). Conversely, excessive tightening of credit policies may reduce risk but limit profit opportunities. Accordingly, optimal financial performance is achieved at a balanced level of credit policies that ensures the quality of the credit portfolio without undermining returns.

The financial performance of banks is associated with a number of key indicators, most notably return on assets (ROA) and return on equity (ROE), which reflect the efficiency of resource utilization, in addition to asset quality indicators such as the ratio of non-performing loans (NPLs), as well as liquidity and capital adequacy indicators. The literature shows that credit policies influence these indicators through multiple channels, including the quality of credit allocation, the efficiency of risk management, and the level of diversification in the credit portfolio (Mishkin, 2016).

In the context of rentier economies, such as Iraq, this relationship becomes more complex, as credit policies are influenced by structural factors, including the dominance of the oil sector, the weakness of the private sector, and the limited depth of the financial system, in addition to institutional and regulatory constraints. This implies that the effectiveness of credit policies depends not only on banking management efficiency, but is also shaped by the broader macroeconomic policy framework, particularly monetary policy and overall economic stability.

Based on the above, the theoretical framework of the study can be formulated on the premise that credit policies represent a critical variable in explaining banks' financial performance, through their direct impact on asset quality and profitability, as well as their indirect effect via risk management and interaction with the macroeconomic environment.

H: Based on the theoretical framework, the study assumes the existence of a statistically significant relationship between credit policy variables and the financial performance of the banking sector, which can be formulated as follows:

Ha: There is a positive relationship between credit volume and banks' financial performance.

Hb: There is a negative relationship between interest rates and banks' financial performance.

Hc: There is a negative relationship between non-performing loans and banks' financial performance.

Hd: There is a negative relationship between loan loss provisions and banks' financial performance.

1-2. Empirical Review:

Credit policies have received increasing attention in banking literature due to their role in guiding lending activities and achieving a balance between profitability and risk. Studies indicate that the efficiency of credit management directly affects financial performance indicators, such as profitability and asset quality. Effective credit policies also contribute to enhancing financial stability and reducing risks, making them a strategic tool in bank management.

In this context, the study by (Kato et al., 2024) examined the impact of credit policies on the financial performance of commercial banks in Uganda using both quantitative and qualitative data, and employing correlation and regression techniques. The findings revealed a positive and statistically significant effect of these policies on financial performance, emphasizing that efficient risk management, proper credit allocation, adoption of modern technology, and staff training are key supporting factors that enhance the effectiveness of credit management and improve banking performance. Similarly, the study by (D & Alabi, 2014) aimed to analyze the impact of credit policies on the performance of commercial banks in Nigeria by applying it to Zenith Bank Plc. The results showed that effective credit policies help reduce non-performing loans and improve asset quality, which positively reflects on bank profitability and the sustainability of its financial performance.

Studies by (Iftikhar, 2016; Isanzu, 2017; Musyoki & Kadubo, 2012), which relied on panel data and econometric analysis, have shown that credit risk indicators have a statistically significant impact on banks' financial performance. The results indicated that non-performing loans, default rates, bad debt costs, and capital adequacy are among the most influential determinants, as their increase is generally associated with a deterioration in profitability indicators such as return on assets (ROA) and return on equity (ROE). These studies also confirmed that the default rate is one of the most powerful explanatory variables of financial performance compared to other indicators, highlighting the

importance of adopting effective credit risk management policies and strengthening evaluation and monitoring mechanisms to mitigate risks and improve banking performance efficiency.

Extending the previous literature, the study by (Tahu et al., 2025) found a significant impact of credit policies on bank profitability (ROA and ROE), with weak risk management being associated with higher non-performing loans, while improvements in liquidity and efficiency were observed when effective policies were adopted. Similarly, the study by (Zaman et al., 2014) identified a statistically significant inverse relationship between interest rates and banks' financial performance. These findings confirm that banking performance is influenced by both the efficiency of credit policies and the broader monetary policy framework.

On the other hand, studies by (Anh et al., 2026; Gao & Guo, 2022; Xu, 2013) examined the impact of green credit on the financial performance of the banking sector. Collectively, they found that adopting green credit policies contributes to improving profitability and enhancing non-traditional revenues, as well as reducing non-performing loans and supporting financial sustainability. The results also indicated that this effect is more pronounced in low-risk banks and regional banks, while the impact of certain factors such as bank size and capital adequacy may be limited or statistically insignificant in some cases. This reflects variations in banks' responses to such policies depending on their structural characteristics and the extent to which they adopt sustainable finance practices.

In the same context, studies by (Amoa et al., 2025; Kwashie et al., 2022; Muriithi et al., 2016) examined the impact of credit risk on the performance and financial sustainability of the banking sector. Using panel data and various econometric models, these studies found that higher levels of non-performing loans and excessive lending negatively affect profitability and financial stability, while improvements in asset quality and deposit mobilization contribute to enhancing performance and sustainability. The results also revealed a statistically significant negative effect of credit risk and interest rates on performance indicators, alongside a positive impact of certain internal and macroeconomic factors such as bank size and economic growth. This underscores the importance of adopting effective credit risk management policies and strengthening banking supervision efficiency.

Furthermore, the study by (Danisman et al., 2020) investigated the impact of economic policy uncertainty on credit growth in European banks during the period (2009–2018), employing panel data, fixed effects models, and GMM estimation. The findings indicated a statistically significant negative effect of uncertainty on credit growth, with variations depending on bank type, legal environment, and bank size. Additionally, the study by (Addury & Ramadhani, 2024) analyzed the impact of Islamic financing modes on the financial stability of Islamic rural banks in Java using panel data and path analysis. The results showed a direct positive effect of profit-sharing financing, in contrast to a statistically significant negative effect of mark-up-based financing, reflecting the importance of managing credit policies to achieve a balance between profitability and financial stability.

The studies by (NGUYEN, 2020; Spaseska et al., 2022) aimed to analyze the impact of capital adequacy on bank profitability. The former relied on panel data for Vietnamese banks during the period (2010–2018), while the latter employed an ARDL model in North Macedonia. The results revealed a positive effect of capital adequacy on profitability, although it was not statistically significant in some cases. Other factors, such as net interest margin, non-interest income, and the ratio of deposits to assets, were found to play an important role in enhancing financial performance, while non-performing loans had a negative impact. These findings highlight the importance of strengthening capital levels and improving the financing structure to support bank profitability and financial stability.

In the same context, the study by (Al-zararee et al., 2021) aimed to evaluate the impact of working capital management and credit policies on the financial performance of Jordanian banks during (2017–2020), using panel data and a multiple regression model. The results showed a statistically significant effect for both variables, with explanatory power reaching (34.1% and 41.8%), confirming the importance of efficient financial and credit management in enhancing performance. Additionally, the study by (Porenta & Rant, 2025) analyzed the financial performance of development

banks compared to commercial banks. The findings indicated that bank characteristics such as size, ownership structure, and operational scope affect indicators of profitability, efficiency, liquidity, loan quality, and capital adequacy, and that banks with limited mandates tend to achieve lower performance efficiency compared to those with broader activities.

The studies by (Athanasoglou et al., 2006; Horobet et al., 2021) aimed to analyze the determinants of bank profitability in European countries. The former relied on panel data for Southeast European countries during the period (1998–2002), while the latter employed the GMM methodology for data from Central and Eastern European countries over (2009–2018). The findings indicated that bank-specific factors represent a primary determinant of profitability, with a positive effect of market concentration, whereas the impact of macroeconomic factors was mixed or unclear in some cases. In contrast, the second study found that variables such as unemployment, inflation, non-performing loans, and capitalization have a statistically significant negative effect on bank profitability, highlighting the importance of improving the macroeconomic environment and enhancing banking management efficiency to support financial performance.

Despite the wide range of studies examining the impact of credit policies on financial performance, most have been conducted in economic environments different from the Iraqi case and have often addressed credit variables in a partial manner rather than integrating them within a unified model. Moreover, their findings have been inconsistent, particularly regarding interest rates and capital adequacy, alongside the limited use of dynamic models that distinguish between the short and long run. Accordingly, this study seeks to fill this gap by providing a comprehensive econometric analysis of the Iraqi banking sector, incorporating the key credit policy variables within a unified framework.

2. Methodology and Data

2-1. Description of Variables and Data

This section of the study aims to present and describe the data used in the econometric analysis, which represent the main variables in the research model that examines the impact of credit policies on the financial performance of the banking sector in the Iraqi economy.

Time-series data covering the period (2003–2025) were utilized in a manner consistent with the nature of the econometric model and the objectives of the study. Return on Assets (ROA) is used as the dependent variable, as it reflects the level of profitability and the efficiency of resource utilization within banks. The independent variables, which represent credit policy instruments and their quality, include total credit (CRE) to measure the scale of lending activity, and net interest margin (NIM) as an indicator of pricing efficiency and financial intermediation. In addition, non-performing loans (NPL) are included to capture the level of credit risk and asset quality, as well as loan loss provisions (LLP), which reflect the degree of prudence and risk management within banks.

Collectively, these variables contribute to explaining variations in banks' financial performance by analyzing the effects of credit volume, pricing efficiency, credit portfolio quality, and the level of risk management on banking profitability

Table (1): Model Functional Specification (Prepared by the Author)

Variable	Symbol	Measurement	Variable Type	Expected Sign
Return on Assets	ROA	Net Profit / Total Assets	Dependent variable	
Total Credit	CRE	Total Loans / Total Assets	independent variable	+
Net Interest Margin	NIM	Net Interest Income / Earning Assets	independent variable	+
Non-Performing Loans	NPL	Non-Performing Loans / Total Loans	independent variable	-
Loan Loss Provisions	LLP	Loan Loss Provisions / Total Loans	independent variable	-

2-2. Model Specification

Based on the theoretical frameworks related to the role of bank credit in achieving profitability, along with the findings of recent empirical studies, an econometric model has been developed to analyze the impact of credit policy instruments on the financial performance of the banking sector in the Iraqi economy. The model incorporates variables that reflect credit volume, pricing efficiency, asset quality, and the level of risk management, with the aim of explaining variations in return on assets as a comprehensive indicator of financial performance, according to the following specification:

$$\Delta ROA_t = \alpha_0 + \sum_{i=1}^n \beta_1 \Delta ROA_{t-i} + \sum_{i=1}^n \beta_2 \Delta CRE_{t-i} + \sum_{i=1}^n \beta_3 \Delta NIM_{t-i} + \sum_{i=1}^n \beta_4 \Delta NPL_{t-i} + \sum_{i=1}^n \beta_5 \Delta LLP_{t-i} + \gamma_1 PROA_{t-1} + \gamma_2 CRE_{t-1} + \gamma_3 RNIM_{t-1} + \gamma_4 NPL_{t-1} + \gamma_5 LLP_{t-1} + \varepsilon_t \quad \dots \dots \dots (1)$$

Where:

Δ : the first difference of the time series.

β : short-run coefficients.

γ : long-run coefficients.

α_0 : the constant term (intercept).

ε_t : the random error term.

3. Empirical Results

3.1 Unit Root Test

The unit root test is a fundamental step in time series analysis to verify the stationarity of variables before estimating the model, particularly in ARDL models to avoid spurious results. The study employed the Augmented (Dickey & Fuller, 1979) (ADF) test at both the level and first difference to determine the order of integration. The results reported in Table (2) indicate that all variables are non-stationary at level but become stationary after first differencing, implying that they are integrated of order one, (I1). Accordingly, these results justify the use of the ARDL model to analyze both short- and long-run relationships among the study variables.

Table (2): Results of the Unit Root Test (Prepared by the Author based on EViews 10 Outputs)

UNIT ROOT TEST RESULTS TABLE (ADF)						
Null Hypothesis: the variable has a unit root						
	At Level					
		ROA	CRE	NIM	NPL	LLP
With Constant	t-Statistic	-1.7694	-2.5350	-2.0375	-1.8980	1.8404
	Prob.	0.3847	0.1213	0.2699	0.3270	0.9995
		n0	n0	n0	n0	n0
With Constant & Trend	t-Statistic	-1.6430	-2.6828	-3.0851	-1.7479	-0.7102
	Prob.	0.7417	0.2519	0.1350	0.6948	0.9594
		n0	n0	n0	n0	n0
Without Constant & Trend	t-Statistic	-1.1213	0.0513	-0.4882	-0.5189	2.2424
	Prob.	0.2298	0.6886	0.4928	0.4802	0.9917
		n0	n0	n0	n0	n0
	At First Difference					
		d(ROA)	d(CRE)	d(NIM)	d(NPL)	d(LLP)
With Constant	t-Statistic	-5.1772	-4.9227	-3.9871	-5.4316	-4.2050
	Prob.	0.0005	0.0008	0.0068	0.0003	0.0040
		***	***	***	***	***
With Constant & Trend	t-Statistic	-5.0201	-4.8481	-3.9096	-5.8265	-5.5517
	Prob.	0.0036	0.0046	0.0313	0.0006	0.0011
		***	***	**	***	***
Without Constant & Trend	t-Statistic	-5.2052	-5.0565	-4.0798	-5.4317	-3.4215
	Prob.	0.0000	0.0000	0.0003	0.0000	0.0016
		***	***	***	***	***

3-2. Results of the Bounds Test, Error Correction Model, and Short-Run and Long-Run Analysis

3-2-1. Cointegration Test Using the Bounds Testing Approach

Using the ARDL Model, the Bounds Test was conducted to examine the existence of a long-run cointegration relationship among the study variables in accordance with the methodology of (Pesaran et al., 2001). This test is based on comparing the calculated F-statistic with the critical values of the lower bound $I(0)$ and the upper bound $I(1)$. The null hypothesis of no cointegration is rejected if the calculated F-statistic exceeds the upper bound critical value, indicating the existence of a long-run equilibrium relationship among the variables.

The results of the Bounds Test reported in Table (3) show that the calculated F-statistic reached (18.44891), which exceeds all upper bound critical values at the various significance levels. Accordingly, the null hypothesis is rejected and the alternative hypothesis is accepted, confirming the existence of a long-run cointegration relationship among the study variables.

3-2-2. Error Correction Model (ECM) Results

The results of the Error Correction Model (ECM) reported in Table (3) show that the error correction coefficient is negative and statistically significant at the 1% significance level, with a value of ($\lambda = -1.431$, $p = 0.0000$). This confirms the existence of a long-run equilibrium relationship among the study variables, consistent with the Bounds Test results based on the methodology of (Pesaran et al., 2001). The negative sign of the coefficient reflects the presence of a self-correcting mechanism that restores the variables to equilibrium after short-run shocks, while the magnitude of the coefficient indicates a high speed of adjustment toward equilibrium.

3-2-3. Short-Run Relationship Analysis

The short-run results reported in Table (3) indicate that total credit has a positive and statistically significant effect on banks' financial performance, reflecting the importance of expanding lending activity in enhancing banking profitability. In contrast, the effect of the net interest margin was positive but statistically insignificant, suggesting the limited effectiveness of the interest rate channel in influencing financial performance in the short run. The results also revealed a negative and statistically significant effect of both non-performing loans and loan loss provisions on return on assets, reflecting the adverse impact of deteriorating credit portfolio quality and rising credit risk on bank profitability.

Table (3): Bounds Test, Cointegration, and Short-Run and Long-Run Estimation Results Using the ARDL Model (Prepared by the Author based on EViews 10 Outputs)

Conditional Error Correction Regression				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.504018	0.151061	3.336511	0.0103
D(ROA(-1))*	-1.431577	0.162980	-8.783778	0.0000
D(CRE(-1))	1.168690	0.321395	3.636310	0.0066
D(NIM)**	0.372380	0.268147	1.388719	0.2024
D(NPL(-1))	-4.554612	1.595125	-2.855333	0.0213
D(LLP(-1))	-0.726939	0.221456	-3.282538	0.0111
D(CRE, 2)	0.512667	0.170038	3.015024	0.0167
D(CRE(-1), 2)	-0.445117	0.152040	-2.927634	0.0191
D(NPL, 2)	0.328427	1.523881	0.215520	0.8348
D(NPL(-1), 2)	3.177902	1.121893	2.832626	0.0221
D(LLP, 2)	-0.655045	0.143313	-4.570726	0.0018
D(LLP(-1), 2)	-0.424629	0.148614	-2.857257	0.0212
Levels Equation				

Case 2: Restricted Constant and No Trend				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(CRE)	0.816366	0.248260	3.288351	0.0110
D(NIM)	0.260119	0.199833	1.301684	0.2293
D(NPL)	-3.181535	1.065429	-2.986153	0.0174
D(LLP)	-0.507789	0.142400	-3.565939	0.0073
C	0.352072	0.101181	3.479629	0.0083
F-Bounds Test		Null Hypothesis: No levels relationship		
Test Statistic	Value	Signif.	I(0)	I(1)
			Asymptotic: n=1000	
F-statistic	18.44891	10%	2.2	3.09
k	4	5%	2.56	3.49
		2.5%	2.88	3.87
		1%	3.29	4.37
Actual Sample Size	20		Finite Sample: n=30	
		10%	2.525	3.56
		5%	3.058	4.223
		1%	4.28	5.84

3-2-4. Analysis of Long-Run Results

The long-run results reported in Table (3) revealed a positive and statistically significant effect of total credit (CRE) on banks' financial performance, with a coefficient value of (0.816366) at a significance level of (0.0110). This indicates that the expansion of lending activity contributes to enhancing return on assets and improving banking profitability in the long run.

As for the net interest margin (NIM), its effect was positive, with a coefficient value of (0.260119), but statistically insignificant at a significance level of (0.2293). This reflects the limited impact of banking pricing efficiency and the interest rate channel on the financial performance of banks in the Iraqi economy.

Regarding non-performing loans (NPL), the results showed a negative and statistically significant effect on return on assets, with a coefficient value of (-3.181535) at a significance level of (0.0174). This indicates that an increase in non-performing loans leads to lower profitability due to deteriorating asset quality and rising credit risk.

The findings also showed that loan loss provisions (LLP) have a negative and statistically significant effect on financial performance, with a coefficient value of (-0.507789) at a significance level of (0.0073). This suggests that increasing provisions reduces bank profitability because part of revenues is allocated to cover potential credit losses and risks.

3-3. Diagnostic Tests

3-3-1. Serial Correlation and Heteroskedasticity Tests

The results of the serial correlation test indicate acceptance of the null hypothesis at the 5% significance level, suggesting that the model is free from the problem of serial correlation. Accordingly, the estimated coefficients can be considered efficient and reliable (Gerrard & Godfrey, 1998). As shown in Table (4), the probability values for both the F-statistic and the Chi-square statistic exceeded the 5% significance level, supporting the validity of the model in this regard.

Similarly, the results of the heteroskedasticity test reported in Table (4) revealed that all probability values were above the 5% significance level, indicating that the null hypothesis of homoskedasticity cannot be rejected. Therefore, the model does not suffer from the problem of heteroskedasticity, which further enhances the reliability of the estimated econometric results.

Table (4): Results of the Serial Correlation and Heteroskedasticity Tests for the Econometric Model (Prepared by the Author based on EViews 10 Outputs)

Breusch-Godfrey Serial Correlation LM Test:			
F-statistic	0.396311	Prob. F(2,6)	0.6892
Obs*R-squared	2.333775	Prob. Chi-Square(2)	0.3113
Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	1.382794	Prob. F(11,8)	0.3299
Obs*R-squared	13.10664	Prob. Chi-Square(11)	0.2864
Scaled explained SS	1.366496	Prob. Chi-Square(11)	0.9998

3-3-2. Residual Normality Test

The Jarque–Bera Test is used to examine whether the residuals of the regression model follow a normal distribution (Gerrard & Godfrey, 1998). The results presented in Figure (1) indicate that the probability value of the Jarque–Bera statistic reached (0.7918), which is higher than the 5% significance level. This implies acceptance of the null hypothesis that the residuals are normally distributed. Accordingly, it can be concluded that the residuals of the model follow a normal distribution.

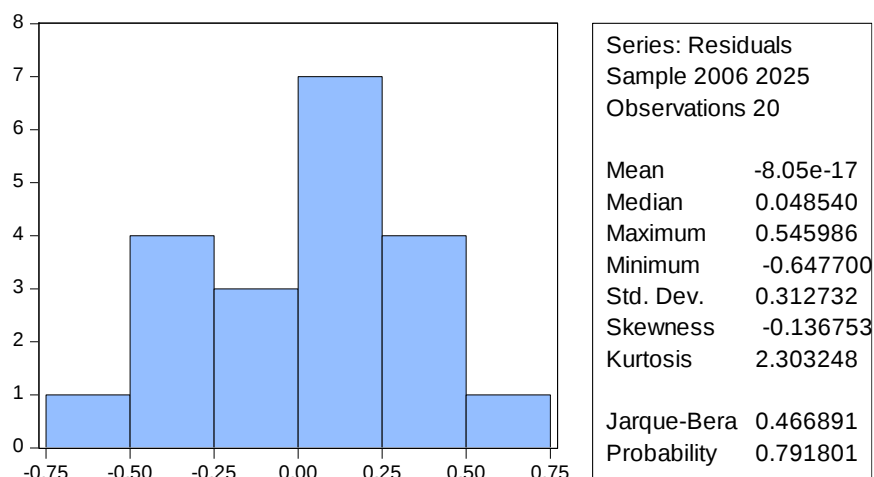


Figure (1): Normality Test (Prepared by the Author Based on EViews 10 Output)

3-3-3. Stability Tests of the Model

The results of the CUSUM and CUSUMSQ tests showed that the test plots remained within the 5% significance boundaries throughout the study period, indicating the stability of the model coefficients and the absence of significant structural changes. These findings suggest that the ARDL model is structurally stable, which enhances the reliability of both the short-run and long-run results.

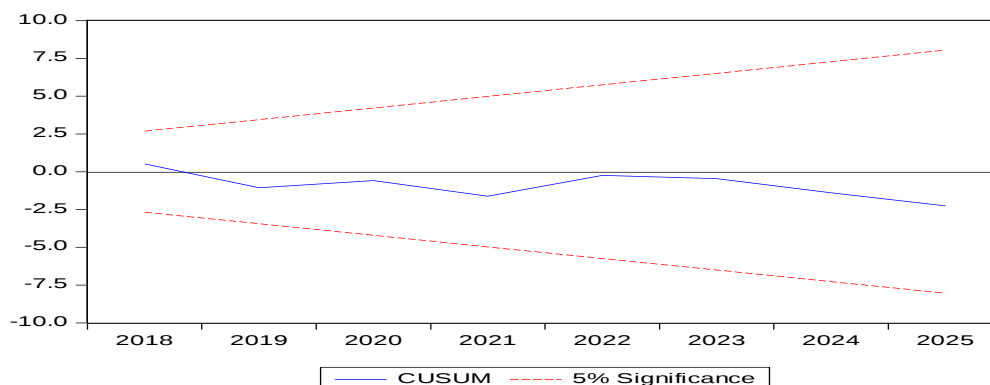


Figure (2): CUSUM Test (Source: Prepared by the Author based on EViews 10 Output)

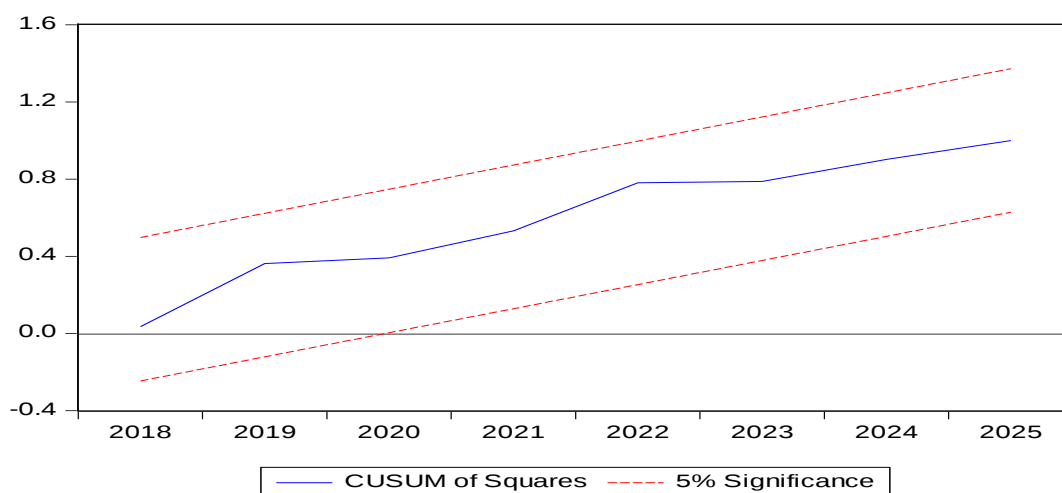


Figure (3): CUSUM of Squares Test (Source: Prepared by the Author based on EViews 10 Output)

4. Discussion

The study results reveal the existence of a long-run equilibrium relationship between credit policy variables and the financial performance of the banking sector in Iraq, confirming the importance of bank credit as one of the main determinants of profitability and financial stability in banks. The findings indicate a positive and statistically significant effect of total credit on financial performance, which is consistent with the studies of (Kato et al., 2024) and (D & Alabi, 2014), both of which emphasized that expanding lending activity and improving credit allocation contribute to enhancing bank profitability and asset quality. This result is also consistent with the theoretical framework of financial intermediation theory, which argues that efficient credit allocation improves banks' financial performance through increasing revenues and enhancing the efficient use of financial resources.

In contrast, the results show that the net interest margin has a positive but statistically insignificant effect, a finding that partially differs from the study of (Zaman et al., 2014), which reported a negative and significant effect of interest rates on banks' financial performance. This result can be explained by the specific characteristics of the Iraqi economy, which is marked by limited financial depth, the dominance of a cash-based economy, and the weak effectiveness of the interest rate channel as a mechanism for transmitting monetary policy effects, thereby reducing the direct influence of interest rate changes on bank profitability.

The study also demonstrates a negative and statistically significant effect of non-performing loans on return on assets, which is consistent with the findings of (Amoa et al., 2025; Iftikhar, 2016; Isanzu, 2017; Musyoki & Kadubo, 2012). These studies collectively confirmed that rising non-performing loans lead to lower profitability due to deteriorating asset quality and increasing credit risk. This result reflects the weakness of credit risk management efficiency within a banking environment characterized by high uncertainty, weak credit guarantees, and limited efficiency of monitoring and evaluation systems.

Similarly, the findings reveal a negative and statistically significant effect of loan loss provisions on banks' financial performance. This result is in line with the literature emphasizing that higher provisions reflect increased credit risk and deterioration in credit portfolio quality, leading banks to allocate part of their revenues to cover potential losses. This finding also corresponds with previous credit risk studies that linked rising bad debt costs and loan loss provisions with declining banking profitability indicators.

Overall, the results suggest that the financial performance of Iraqi banks is more strongly influenced by credit quality and risk management than by monetary pricing instruments. This reflects the structural nature of the Iraqi economy as a rentier economy heavily dependent on the oil sector, characterized by underdeveloped financial markets and a weak contribution from the private sector. The findings further indicate that improving banks' financial performance does not depend solely on expanding credit, but also requires the development of risk management systems, enhancement of asset quality, and improvement of credit supervision and monitoring mechanisms.

In light of these findings, enhancing the effectiveness of credit policies in Iraq requires improving the institutional and regulatory environment of the banking sector, modernizing risk management systems, and expanding the use of modern technologies in credit assessment. Such measures would contribute to improving financial intermediation efficiency and strengthening long-term financial stability. Future studies may also incorporate additional macroeconomic variables, such as exchange rates, monetary stability, and banking governance, or employ more advanced econometric models to analyze differences between public and private banks and to measure the impact of economic shocks on credit quality and financial performance.

5. Conclusions

The study aimed to analyze the impact of credit policies on the financial performance of the banking sector in Iraq using a modern econometric framework within the ARDL Model, in order to identify the nature of the relationship between credit variables and financial performance indicators in both the short and long run. The study found evidence of a long-run equilibrium relationship between credit policy variables and banks' financial performance, as confirmed by the Bounds Test and the Error Correction Model results. The findings also revealed a positive and statistically significant effect of total credit on financial performance, reflecting the importance of expanding lending activity in enhancing banking profitability in the long run. In contrast, the effect of the net interest margin was positive but statistically insignificant, indicating the limited role of the interest rate channel in explaining banks' financial performance in the Iraqi economy. On the other hand, the results showed a negative and statistically significant effect of both non-performing loans and loan loss provisions on return on assets, reflecting the adverse impact of rising credit risk and deteriorating credit portfolio quality on bank profitability. Accordingly, the study emphasizes the importance of adopting sound credit policies that enhance asset quality and improve credit risk management, thereby supporting financial stability and improving the efficiency and performance of the banking sector in Iraq.

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