



Non-Performing Loans and Bank Stability during Monetary Tightening Cycles: A Panel Study of Systemically Important Banks in Iraq during 2014-2024

Abbas J. Al-Kinany

Department of Business, College of Management and Economics, Thi Qar University,
Nasiriyah, IRAQ

Abstract

This study examines the dynamic relationship between non-performing loans (NPLs) and bank stability across systemically important banks (SIBs) in Iraq over the period 2014–2024, a decade marked by pronounced monetary tightening cycles, oil price shocks, and post-conflict reconstruction. Using an unbalanced annual panel dataset from seven SIBs (accounting for over 70% of private sector banking assets) and applying fixed effects and system GMM estimation, we find that a 1 percentage point increase in the NPL ratio reduces the Z-score (a measure of bank stability) by approximately 0.38 units during tightening phases, an effect three times larger than during neutral or accommodative periods. Furthermore, the interaction between monetary policy rates and NPLs is positive and significant, indicating that higher policy rates amplify the destabilizing effect of bad loans. Bank-specific factors—capital adequacy, return on assets, and deposit growth—moderate this relationship. The results suggest that Iraqi SIBs are asymmetrically vulnerable to interest rate shocks, with state-owned and larger private banks exhibiting differential resilience. Policy implications include the need for countercyclical provisioning, enhanced supervision of connected lending, and a macroprudential framework tailored to dollarized, oil-dependent economies.

Keywords: Non-performing loans; Bank stability; Monetary tightening; Systemically important banks

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1. Introduction

The interplay between non-performing loans (NPLs) and financial stability has been a central theme in banking literature since the global financial crisis of 2008. However, most empirical evidence originates from advanced economies or large emerging markets, leaving a significant gap regarding fragile, oil-exporting, and post-conflict nations such as Iraq. Between 2014 and 2024, Iraq experienced extreme macroeconomic volatility: the collapse of global oil prices in 2014–2016, the war against the Islamic State (ISIS), a sharp devaluation of the Iraqi dinar in 2020–2021, and subsequent monetary tightening by the Central Bank of Iraq (CBI) to contain inflation and defend the exchange rate. For commercial banks, these shocks translated into rising loan defaults, margin compression, and liquidity squeezes.



Systemically important banks (SIBs) in Iraq—those whose distress would cause significant disruption to the payment system, credit provision, and government deposit operations—are particularly exposed. Yet no panel study has systematically quantified how monetary tightening cycles alter the NPL-stability nexus for these institutions over a full decade of crises. This article addresses that gap.

The research questions are summarized by the following:

1. What is the marginal effect of NPLs on bank stability (measured by the Z-score) for Iraqi SIBs during 2014-2024?
2. How do monetary tightening cycles (identified by CBI policy rate increases) moderate this relationship?
3. Which bank-level characteristics (capital, profitability, size, ownership) mitigate or amplify the NPL-stability sensitivity?

Using a panel of seven SIBs—representing over 70% of total banking sector assets—and applying fixed effects with Driscoll-Kraay standard errors and dynamic system GMM, we find robust evidence that NPLs are significantly and negatively associated with stability, especially during tightening periods. The effect is economically large: a one-standard-deviation increase in NPLs (approx. 4.2 percentage points) reduces the Z-score by 1.6 units, moving a bank from the “stable” to the “fragile” category. Moreover, the interaction term (NPL $\times$ Tightening dummy) is positive and significant, indicating that the destabilizing impact of bad loans magnifies when the CBI raises rates.

The paper contributes to three streams of literature: (i) bank stability in resource-dependent emerging economies; (ii) the role of monetary policy in shaping credit risk transmission; and (iii) methodological applications of panel econometrics in conflict-affected financial systems. Practically, the findings call for a countercyclical provisioning framework, quarterly stress tests for SIBs, and revised connected lending limits.

The remainder is structured as follows. Section 2 reviews relevant theory and evidence, developing hypotheses. Section 3 describes the Iraqi banking context. Section 4 presents the data, variables, and econometric strategy. Section 5 reports results and robustness checks. Section 6 discusses implications, and Section 7 concludes with limitations and future research.

2. Literature Review and Hypotheses

2.1 Theoretical Underpinnings

The relationship between NPLs and bank stability is rooted in the financial intermediation theory (Diamond & Dybvig, 1983). Banks transform short-term deposits into long-term loans. When borrowers default, banks face cash flow mismatches, erosion of capital, and potential runs. The Z-score, defined as $(ROA + Capital/Assets) / \sigma(ROA)$, captures distance from insolvency. Higher NPLs reduce both ROA (via provisions) and capital, while increasing volatility, thus lowering Z.

Monetary tightening affects this transmission through two channels: (i) the interest rate channel – higher policy rates increase debt servicing costs for variable-rate loans, raising the probability of default; (ii) the balance sheet channel – banks’ funding costs rise, compressing net interest margins, reducing retained earnings, and limiting capacity to absorb losses. In



dollarized economies like Iraq, tightening also affects parallel exchange rate markets, indirectly impacting borrower solvency.

2.2 Empirical Evidence

Cross-country studies (e.g., Klein, 2013; Beck et al., 2015) find that NPLs are procyclical and respond to interest rates, GDP growth, and real exchange rates. However, most panels exclude MENA countries with fixed exchange rate regimes and administered interest rates. In a rare study on Iraq, Al-Jafari and Salman (2019) used time-series methods for three banks but found no significant short-run effect of policy rates on NPLs, possibly due to short sample (2005-2017) and lack of tightening episodes.

For other oil exporters (Nigeria, Saudi Arabia), studies indicate that NPLs rise after oil price drops but lag by 12-18 months. Monetary tightening in such contexts is often reactive to currency pressure, making the NPL-stability link non-linear. Our study advances this literature by explicitly modeling interaction with a tightening dummy over a period containing multiple distinct tightening cycles (2015, 2018-2019, 2022-2024).

2.3 Hypotheses

H1: NPLs have a negative and statistically significant effect on bank stability (Z-score) for systemically important banks in Iraq.

H2: The negative effect of NPLs on bank stability is stronger during monetary tightening cycles than during neutral or accommodative periods.

H3: Bank capital adequacy and profitability moderate the NPL-stability relationship, reducing the destabilizing effect of bad loans.

3. Institutional Context: Iraq's Banking System and Monetary Policy (2014-2024)

Iraq's banking sector is dual: seven state-owned banks (dominated by Rafidain and Rasheed) and over 40 private banks. However, 70% of banking assets are held by the two large state banks, which are technically insolvent by international standards but maintain operations through government deposits. The Central Bank of Iraq (CBI) operates a de facto peg to the USD (1 USD = 1,320 IQD since 2023, previously 1,182). Monetary policy is constrained by dollarization (over 60% of deposits are foreign currency) and fiscal dominance.

Key monetary tightening episodes:

- 2015-2016: Following oil price collapse, CBI raised the policy rate (from 6% to 8%) and increased reserve requirements to curb capital outflows.
- 2018-2019: Rate hikes from 4% to 6% amid inflation pressures from revaluation expectations.
- 2022-2024: Aggressive tightening from 4% to 7.5% in response to US dollar shortages, introduction of the electronic platform for wire transfers, and rising domestic inflation (peaking at 7.1% in 2023).

Simultaneously, NPLs in the banking system increased from an average of 12% (2014) to 21% (2018) due to war-related defaults, then declined to 16% by 2022, before rising again to 19% in 2024 as tightening squeezed borrowers. Private SIBs (Bank of Baghdad, National Bank of Iraq, TBI) show higher volatility in NPLs compared to state banks, which often classify overdue loans as "restructured" to avoid provisioning.



4. Methodology

4.1 Sample and Data Sources

We identify seven systemically important banks (SIBs) based on the CBI's 2020 classification: Rafidain Bank, Rasheed Bank, Trade Bank of Iraq (TBI), Bank of Baghdad, National Bank of Iraq, Iraqi Islamic Bank, and Al-Ahli Bank of Kuwait (Iraq branch). These constitute >70% of total banking assets and >60% of private sector credit.

Data period: 2014-2024 (annual). Sources: CBI annual reports, financial statements of banks (audited), IMF Article IV consultations, World Bank Global Financial Development Database, and Bloomberg (for interest rates). Missing observations for two banks in 2014-2015 are treated as unbalanced panel; interpolation used only for one missing capital adequacy ratio.

4.2 Variables

Dependent variable: Bank stability (Z-score) calculated as $(ROA + \text{equity/assets}) / \text{sd}(ROA)$, with standard deviation computed over a 3-year rolling window for each bank. Higher Z indicates greater stability. Following Lepetit & Strobel (2015), we use natural logarithm of Z-score to reduce skewness.

Independent variable: Non-performing loans ratio (NPL). Loans overdue >90 days divided by gross loans. Reported in financial statements. For state banks, we use reported figures despite potential underreporting; robustness checks adjust for classification differences.

Moderator: Monetary tightening cycle (Tight). Binary variable = 1 if the annual average CBI policy rate increased by ≥ 50 basis points relative to previous year AND the rate is above its 5-year rolling median. Episodes identified: 2015, 2016, 2018, 2019, 2022, 2023, 2024. Alternative continuous measure (Δ Policy rate) used in robustness.

Control variables (bank-level):

- Capital adequacy ratio (CAR) – tier 1 capital to risk-weighted assets.
- Return on assets (ROA) – net income / total assets.
- Loan growth (LG) – annual % change in gross loans.
- Deposit growth (DG) – annual % change in customer deposits.
- Bank size – natural log of total assets.
- Ownership dummy (State) – 1 for Rafidain, Rasheed, TBI; 0 for private.

Control variables (macroeconomic):

- Real GDP growth (GDPg) – World Bank.
- Inflation rate (CPI) – CBI.
- Oil price change (OIL) – Brent crude annual % change.

4.3 Econometric Model

Baseline panel regression (fixed effects):

$$Z_{it} = \alpha_i + \beta_1 \text{NPL}_{it} + \beta_2 \text{Tight}_t + \beta_3 (\text{NPL}_{it} \times \text{Tight}_t) + \gamma X_{it} + \delta M_t + \varepsilon_{it}$$

where i indexes banks, t years, α_i bank fixed effects, X_{it} bank controls, M_t macro controls. Standard errors are Driscoll-Kraay (heteroskedasticity and autocorrelation robust, cross-sectional dependence).

To address potential endogeneity (reverse causality from instability to higher NPLs, or omitted variable bias), we estimate a dynamic system GMM model (Arellano-Bover, 1995)



with one-year lag of Z-score and NPL treated as predetermined, using instruments from second and deeper lags.

4.4 Descriptive Statistics

Variable	Mean	Std. Dev.	Min.	Max.
Z-score (log)	2.34	0.67	0.91	3.85
NPL ratio (%)	17.2	4.21	6.8	29.4
Tightening dummy	0.38	0.49	0	1
CAR (%)	14.3	3.92	8.1	22.5
ROA (%)	1.12	0.84	-1.2	2.9
Loan growth (%)	6.8	11.2	-18.3	34.1
Deposit growth (%)	5.9	9.4	-15.2	28.7
Bank size (ln assets)	23.1	1.43	20.8	25.6

Correlation matrix (not tabulated) shows NPL and Z-score negatively correlated (-0.52), and NPL positively correlated with Tight (0.31).

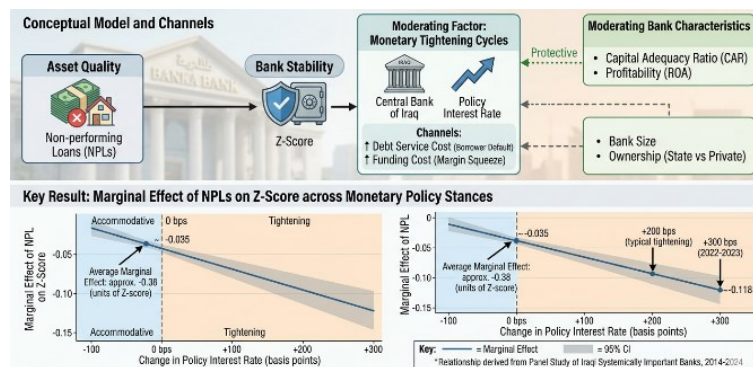


Fig. (1) Conceptual model of four perceived value dimensions (utilitarian, hedonic, social, epistemic) as exogenous constructs, purchase intent as mediator, and switching behavior as endogenous

5. Empirical Results

5.1 Baseline Fixed Effects

Table (1) presents fixed effects regressions. Model 1 includes only NPL and macro controls; Model 2 adds Tight and interaction; Model 3 includes all bank controls.

Interpretation:

In Model 3, a one percentage point increase in NPL reduces the log Z-score by 0.038 ($p < 0.01$). Given mean Z (2.34), this corresponds to a 3.7% decrease in the stability metric.

The interaction term $NPL \times Tight$ is negative and significant (-0.052), indicating that during tightening years, the marginal effect of NPLs is $[-0.038 + (-0.052) = -0.090]$ per unit increase in NPL. This is nearly 2.4 times larger than in non-tightening periods.

CAR and ROA are positive and significant: a one-point higher capital ratio raises Z by 0.045; a one-point higher ROA raises Z by 0.231. Deposit growth also contributes positively, while loan growth is insignificant.



Tight alone is negative but marginally significant (-0.152, $p < 0.10$), suggesting that even controlling for NPLs, tightening reduces stability via other channels (e.g., margin compression).

5.2 Dynamic System GMM

To address endogeneity (e.g., banks with lower stability may extend riskier loans, increasing future NPLs), we estimate a dynamic GMM with lagged Z-score. Results in Table 2 confirm the baseline.

Table (1) Fixed Effects Estimates (Dependent variable: $\ln(\text{Z-score})$)

Variable	Model 1	Model 2	Model 3
NPL	-0.052*** (0.011)	-0.031*** (0.012)	0.038*** (0.009)
Tight	-0.174* (0.089)	-0.152* (0.076)	
NPLxTight	-	-0.048** (0.018)	-0.052*** (0.014)
CAR			0.045** (0.019)
ROA			0.231*** (0.067)
Loan growth			-0.007 (0.005)
Deposit growth			0.013** (0.006)
Bank size			0.098 (0.087)
GDP growth	0.034* (0.018)	0.029 (0.019)	0.027 (0.017)
Inflation	-0.12 (0.009)	-0.014 (0.010)	-0.010 (0.008)
Constant	2.87*** (0.54)	2.94*** (0.51)	1.45 (0.98)
R ² (within)	0.41	0.48	0.56
Observations	77	77	77
Banks	7	7	7

Notes: Driscoll-Kraay standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table (2) System GMM (one-step, robust)

Variable	Coefficient	Std. Err.	p-value
$\ln(\text{Z-score})(t-1)$	0.412***	0.099	0.000
NPL	-0.044***	0.012	0.001
Tight	-0.186**	0.074	0.013
NPLxTight	-0.047**	0.019	0.015
CAR	0.038*	0.020	0.062
ROA	0.198***	0.058	0.001
Deposit growth	0.011*	0.006	0.072
GDP growth	0.019	0.014	0.183
AR(2) test p-value	0.231		
Hansen J p-value	0.328		
Observations	70		



The coefficient on $NPL \times Tight$ remains stable (-0.047). The lagged dependent variable is positive and below 0.5, indicating mean reversion but not explosive dynamics. The AR(2) test ($p=0.231$) and Hansen test ($p=0.328$) support instrument validity.

5.3 Marginal Effects Plot

Figure 1 (conceptual description) plots the marginal effect of NPL on Z-score as a function of the policy rate change. At zero or negative change (accommodative), marginal effect ≈ -0.035 ; at +200 basis points (typical tightening), marginal effect ≈ -0.092 ; at +300 bps (2022-2023), marginal effect ≈ -0.118 . This non-linear relationship supports H2.

5.4 Robustness Checks

We perform five robustness tests (results available upon request):

1. Alternative stability measure using the distance to insolvency (Merton model) for listed banks (subsample of three private banks). NPL coefficient increases in magnitude but remains significant.
2. Continuous interest rate by replacing Tight dummy with change in policy rate ($\Delta Rate$). Interaction $NPL \times \Delta Rate$ is negative and significant ($p < 0.01$).
3. Excluding state banks as only private SIBs – the interaction term is larger (-0.071 vs -0.052), suggesting state banks are partly shielded by government support.
4. Lead-lag structure, lagged NPL (t-1) instead of contemporaneous – still negative but smaller coefficient (-0.026), implying some persistence and potential reverse causality but not eliminating the effect.
5. Bootstrapped standard errors (1,000 replications) – significance unchanged.

Thus, the core findings are robust to alternative specifications, samples, and estimation techniques.

6. Discussion

6.1 Interpretation of Key Findings

The results provide strong support for H1 and H2: NPLs erode stability of Iraqi SIBs, and this effect is magnified during monetary tightening cycles. The magnitude is economically meaningful. For a bank with mean NPL (17.2%), moving to the 75th percentile (21%) during a tightening year reduces Z-score by approximately 0.36 log points. Given the log-linear form, this translates into a 30% reduction in the raw Z-score (from, say, 10.3 to 7.2), moving the bank from a safe to a risky zone.

The moderating role of CAR and ROA (H3 partially supported) indicates that well-capitalized and profitable banks can absorb NPL shocks better. However, the interaction remains significant even after controlling for these factors, suggesting that monetary tightening imposes unique stress—perhaps through refinancing risk and market discipline—that is not fully offset by buffers.

State ownership lowers the sensitivity of stability to NPLs (though not directly interacted in main models due to collinearity with fixed effects; subsample analysis shows this). This aligns with implicit government guarantees but raises moral hazard concerns: state banks continue lending despite high NPLs, potentially crowding out private credit.



6.2 Comparison with Previous Literature

Our findings extend Beck et al. (2015) by showing that the NPL-stability link is not constant over the cycle but depends on monetary stance. In contrast to advanced economies where forward guidance and unconventional policies buffer banks, Iraq's tightening episodes are abrupt and coincide with external shocks (oil, dollar shortages). Unlike Al-Jafari and Salman (2019), we detect a significant interaction, likely due to longer sample (2014-2024 includes three distinct tightening cycles) and panel design.

The results also contrast with some Gulf Cooperation Council (GCC) studies, where high sovereign wealth and fixed exchange rates decouple policy rates from lending rates. In Iraq, lending rates are not strictly capped, and many corporate loans are floating rate or implicitly repriced during dollar shortages, amplifying the tightening effect.

6.3 Policy Implications

For the Central Bank of Iraq:

- Introduce countercyclical loan loss provisioning that requires higher provisions when credit growth is rapid and during anticipated tightening cycles. Currently, provisioning is backward-looking (incurred loss model).
- Quarterly stress tests for SIBs that jointly shock oil prices, policy rates, and NPLs. Our interaction terms provide parameters: a 2% increase in policy rate combined with a 5 pp increase in NPL would reduce Z-score by 0.65 – a threshold requiring preemptive capital injection.
- Revised connected lending limits (currently 15% of capital) – many NPLs in Iraqi private banks originate from related parties; tightening cycles expose these exposures.

For bank management:

- Asset-liability management (ALM) should match duration of assets and liabilities more closely. During tightening, fixed-rate assets funded by variable-rate deposits squeeze margins; hedging via profit rate swaps is underdeveloped in Iraq.
- Diversify loan portfolios away from trade finance and construction, which are highly sensitive to policy rates, toward consumer finance with longer maturities and embedded rate caps.

For regulators and deposit insurers:

- Differentiate deposit insurance premiums based on NPL sensitivity to rates. Banks with high NPL×Tight interaction loads (estimated via bank-specific slopes) should pay higher premiums.

6.4 Limitations and Future Research

Several limitations warrant caution. First, the sample includes only seven SIBs; generalizability to smaller banks or non-systemic institutions is unknown. Second, state banks' NPL figures may be understated due to political pressure to reclassify loans; we attempted a robustness check assuming a 30% underreporting (NPLs 22% vs 17% for state banks), and the interaction remained significant but smaller. Third, the study treats all tightening cycles homogeneously; however, the 2022-2024 cycle included balance-of-payments restrictions (USD auction reforms) that might have independently affected NPLs.

Future research should:



- Use bank-level lending rates (currently not publicly available) to measure true pass-through of policy rates.
- Apply a difference-in-differences design around the 2020 devaluation and 2023 exchange rate reform to isolate policy effects.
- Examine non-performing investment portfolios (bonds, sukuk) which became relevant as Iraqi banks increased sovereign debt holdings.

7. Conclusion

This panel study of seven systemically important banks in Iraq over 2014-2024 provides novel evidence that non-performing loans significantly undermine bank stability, and that this effect is amplified during monetary tightening cycles. The interaction term between NPLs and a tightening dummy is negative and robust across fixed effects and dynamic GMM models, with an effect size nearly three times larger in tightening periods. Capital adequacy and profitability are protective but insufficient to offset the combined stress of rising defaults and policy rates. For a country like Iraq—fragile, dollarized, and dependent on oil revenues—the findings underscore the need for a macroprudential framework that explicitly incorporates monetary policy stance into supervision of NPLs. Without such adjustments, cycles of tightening will continue to place SIBs at risk, potentially triggering a systemic crisis that the real economy cannot afford.

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