



IRAQ: FINANCIAL SECTOR REVIEW

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Introduction: The link between sound and well-developed financial systems and economic growth is fundamental. Efficient and prudent allocation of resources by the financial system is critical for increasing productivity, boosting economic development, enhancing equality of opportunity, and reducing poverty.

The Iraqi Financial System: The financial sector in Iraq remains underdeveloped and underperforming. The banking system is by far the most important part of the financial system, accounting for over 75 percent of assets and is overwhelmingly state-owned. Non-bank institutions and markets are small and underdeveloped. Access to finance is impeded by a weak financial infrastructure, which needs strengthening in all areas: credit registry, the collateral framework, judicial systems, and accounting and auditing skills. It is also important to keep in view the political context. The difficult security situation imposes costs and constraints, the complex political situation impedes decisive policy action, governance issues linger, and the impact of state intervention continues despite reforms.

The Banking System: Seven state banks dominate, in particular, Rafidain Bank and Rasheed Bank. Private Banks are generally quite small and many have been established relatively recently. Seven of the 36 private

banks have foreign participation and eight operate according to Islamic principles. Estimates indicate that state banks account for 86 percent of bank assets and 69 percent of credits. Overall, the banking system is relatively small, with an adjusted asset to GDP ratio of 73 percent compared to 130 percent for the Middle East and North Africa (MENA) region. Although growing rapidly in 2010, lending only amounted to 10 percent of GDP compared to 55 percent for the MENA region as a whole. As a corollary, banks are very liquid and foreign assets and redeposited at the Central Bank of Iraq (CBI) amount to 63 percent of assets.

State-Owned Banks: The operations of Rafidain and Rasheed Banks, the two largest state banks, are inefficient and both suffer from the legacy of past losses, as well as from performing quasi fiscal operations. Reforms have been significantly delayed, especially compared to the time-line in the 2006 Memorandum of Understanding (MOU) between the CBI and the Ministry of Finance. A World Bank project has been supporting the reform process since 2009. The reform process needs to be accelerated, including removing disputed items from their balance sheets and transferring these to a new asset/liability management company. As part of the overall strategy, state banks must become subject to normal supervision by the CBI.

More fundamentally, the authorities need to consider the relative roles of state-owned and private banks, including the role to be assigned to the TBI. The TBI was set up as a specialized trade bank, but now operates as a general commercial bank and has become an important player in the financial system.

¹ This Quick Note is based on the Iraq Financial Sector Review prepared by a World Bank team led by Ms. Sahar Nasr. The review will be available in full on September 23, 2011 and can be accessed at www.worldbank.org/iq. This Quick Note was cleared by Mr. Simon C. Bell, Sector Manager, Finance and Private Sector, Middle East and North Africa Region, The World Bank.

Private Banks: These face an uneven playing field. State banks benefit from the perception of a de facto deposit guarantee and from restrictions imposed on private bank operations. Government agencies and state owned enterprises cannot place deposits with private banks. Nor can state-owned enterprises receive loans from private banks. Moreover, payments to the government (taxes, etc.) cannot be undertaken by checks drawn from private banks. Discussions are under way among private banks to set up a self-funded deposit guarantee fund, but these are at an early stage.

The strength and business expertise of the 36 small private banks appears to be improving. Several offer a range of products, including consumer loans. However, staff skills are often weak, the range of services provided by many banks is still limited, and loans are mainly short term loans related to wholesale and retail trade. Because of their small size, private banks are not yet able to finance large projects, as syndication is not yet used. Some observers, including CBI officials question the professionalism of private banks and are concerned that they are not yet able to effectively support rapid economic growth.

Foreign banks have shown increasing interest in conducting business in Iraq. Currently, many foreign banks mainly focus on foreign companies in oil and related activities. However, over time they should help improve the overall banking climate and spur the development of the financial sector.

Profitability of banks is generally good, but a decline in profits for private banks in 2010 needs watching. State banks are de facto exempted from meeting prudential requirements, and some of them would otherwise fail because of low capital. Prudential indicators for most, though not all, private banks are relatively strong. Prudential and performance indicators for Islamic and conventional private banks are broadly similar. Islamic banks fund themselves more from capital and give a larger share of long term loans.

Challenges in the Banking System: There are concerns that banks may be weaker than they

appear. Accounting and auditing standards are lax and banking supervision needs to be strengthened. Still, most banks appear to be well capitalized, and with strengthened banking supervision and a leveling of the playing field, the majority of private banks should continue to grow and gradually provide the financial underpinnings for stronger non-oil growth. The planned gradual increase in minimum capital requirements will help promote consolidation and further strengthen private banks.

The banking system does not appear to give rise to significant macro-prudential risk at present. Private banks are small, highly liquid, and have strong prudential indicators. While Rafidain Bank and Rasheed Bank clearly require recapitalization, they are still highly liquid, with cash, deposits at the CBI, and foreign assets covering 97 percent of private deposits. Bringing the capital level of all state banks up to the new minimum level by June 2013 could require a capital injection equivalent to 1.4 percent of GDP.

Access to Finance Issues: As noted, bank credit is relatively low and access to other forms of finance also needs improvement. A USAID project team estimates that less than 5 percent of SME's in the formal sector have ever received a bank loan. The authorities and donors have only recently started to focus on micro-finance. There are no good estimates for unsatisfied credit demand. As a simple yardstick, to bring the credit to GDP ratio from 10 percent of GDP to the MENA average of 55 percent will require an increase in credit of ID 45 trillion or approximately \$400 million. The planned increase in bank capital levels will be sufficient to support such a lending level. However, depending on whether or not credit growth does outpace the banks' risk management skills or the capacity of the CBI to supervise banks' rapid growth, such an increase in credit within a short time may bear the risk that asset quality deteriorates.

The Financial Architecture: Weak financial infrastructure is a clear impediment to access to finance in Iraq. Actions are needed in all areas, including a credit registry, the collateral framework, judicial systems, and accounting

and auditing skills. Improving accounting and auditing skills and eventually moving to international standards are particularly important. This would help ensure the transparency of banks and allow banks to identify creditworthy clients. More reliable accounts are also critical for better quality share issuance prospectuses, and for the development of a reliable financial media. The authorities must also undertake a concerted effort to improve the business environment and to strengthen the real economy.

The Payments System: This is relatively well developed, representing, in part, significant technical support from foreign donors. A Real Time Gross Settlement System (RTGS) and an electronic netting system for smaller payments orders were implemented in 2006. An electronic clearing system for checks is expected to be operational at the end of 2011 and the authorities are working with donors to further strengthen the retail payment system, including through a universal switch for bank cards. Nevertheless, the use of cash remains high.

Supervision of Banks: The system of banking laws and regulations provides a workable framework for the exercise of banking supervision, provided rules are implemented and enforced vigorously. A full expert-assisted self-assessment of the supervisory system, based on the Basel Core Principles and the 2006 assessment methodology, is required to further align the system to international standards. However, there are three prerequisites for the CBI to be able to fully deploy effective supervision: (i) ensuring the political will to let the CBI perform its tasks without interference, (ii) assuring that state owned banks are effectively supervised by the CBI in full accordance with the 2006 Memoranda of Understanding (MOU) between the CBI and the Minister of Finance, (iii) ensuring that the CBI has the resources, financial and human, to effectively supervise these large institutions with their many branches.

For optimal effectiveness of current rules and regulations, enforcement needs to be strengthened, and banks rated three under the

CAMELS² system need to be monitored to prevent further slippage in safety and soundness. The Banking sector's financial and prudential information needs to become more reliable and more rapidly accessible by introducing International Financial Reporting Standards (IFRS)-compliant accounting standards, internationally acceptable auditing standards, and a chart of accounts to assure consistency across the system in compiling figures needed for IFRS compliant accounts. Obligations to publish timely audited financial statements must be enforced more forcefully. Islamic banks must be brought under the purview of regular CBI regulations and supervision through rapid adoption of the draft Islamic banking law, and the associated regulations.

Politically supported, robust, concerted efforts must be made to prevent abuse and undermining of the financial system through corruption, money laundering and the potential financing of terrorism.

Capital Markets: The capital market in Iraq is concentrated on the Iraq Stock Exchange (ISX). The stock exchange is small and underdeveloped but has significant potential. It is currently at a crucial stage of its development. Activating the privatization program to place at least a proportion of the shares of currently state owned companies into the hands of Iraqi citizens and institutional and foreign portfolio investors could, over several years, see ISX rival its regional peers in size and depth.

It is probable that there is (unsatisfied) demand from life insurance companies and pension funds for medium/long term debt securities in order to match long term liabilities with long term assets. There appears to be no issuance of such securities currently by either the government or the private sector. The absence of government debt beyond one year inhibits

² An international bank-rating system where bank supervisory authorities rate institutions according to six factors represented by the acronym "CAMELS." This refers to Capital adequacy, Asset quality, Management quality Earnings, Liquidity, and Sensitivity to Market Risk

the latter as there is no “risk free” yield curve to use to price corporate bond issues. Capital market development requires improvements in all the necessary underpinnings of a market in which issuers and investors can have confidence. These include laws on contract enforcement, shareholder and creditors rights, efficient and fair judicial processes, corporate governance and accounting and auditing standards which (at least) match regional benchmarks.

It also requires an effective, fair and efficient regulatory framework within which to operate. This should have as its objectives the protection of investors, ensuring that the market is fair, efficient and transparent and the reduction of systemic risk.

Legislative changes: Legislative reforms to achieve these ends have been discussed since 2008 and steps should now be taken to implement these. The larger report sets out amendments which would enhance the current draft Securities Law. They would also provide a stronger foundation on which the permanent Iraq Securities Commission (ISC) could draft and enforce its regulations. Currently little is known about the interim ISC’s capacity, competencies or goals as it did not take part in the review process. It appears however that the current legislative and regulatory framework under which the ISC operates is weak and underdeveloped. The current Companies Law, although amended in 2004, was written in 1997 and also needs further updating to better achieve good corporate governance in joint stock companies and to secure improved shareholders rights.

Insurance and Pensions Sectors: The insurance sector in Iraq is dominated by state owned insurance companies that benefit from being the sole provider of insurance services to the government. The law requires the government to make use of a public tender process when purchasing insurance services. However, even though the public process is used there is little trust in the market in its fairness, because it is always the state owned insurance companies that are awarded the contracts. There are a number of private sector insurance companies but the number is uncertain because some of them are very small and sometimes it is unclear

whether these small companies are active. The participants in the insurance sector feel a strong need for strengthening of the supervision of the insurance sector.

The government has taken some measures to improve the legal and supervisory framework for the insurance sector. A new insurance law, the Insurance Business Regulation Act from 2005 has been passed and a supervisor has been established. The next steps should be to make the supervisor operational so that its role is made known to market participants and it commences the supervisory activities the present legislation allows. The current legislation on insurance should be strengthened and brought in compliance with the international best practice. It is particularly important that the new legislation provides the supervisor with the power to conduct on-site inspections at the insurers’ place of business. The long-term goal should be to establish a modern legal framework and proper supervision of the insurance sector.

The pension sector in Iraq is going through a transition period with a new law to merge older pension schemes into a single pension fund with the help of the Bank’s PRISTA project³. At present pension funds have weak supervision requirements and it is critical that these are incorporated now, since it will be very difficult to put these into place after the new fund has been established.

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³ For more see:

<http://siteresources.worldbank.org/IRFFI/Resources/PensionReformSep2010.pdf>

