

World Bank Iraq Trust Fund

Update to IRFFI Donor Committee
Naples, Italy – February 18, 2009

Banking Sector Reform Project

I. BACKGROUND / KEY DEVELOPMENT ISSUES

1. The Republic of Iraq has been adversely affected by internal and external shocks. A series of wars, international sanctions and misdirected economic policies have left the country's economy and especially its financial sector weak and underdeveloped.

2. Financial intermediation in Iraq is weak. Although the banking sector is the main component of the Iraqi financial system, it offers few credit facilities, despite the fact that most branches resumed operations after 2003. The credit culture is poor with very little extension of credit to the private sector and an asset composition heavily tilted toward government securities. Very few banks offer loans with more than one year maturity as most banks lack the expertise to offer appropriate credit facilities or assess risks.¹ Compared to some other countries in the region the deposit base and loan portfolio of Iraqi banks is small. The Government of Iraq (GOI) must move as quickly as possible to reform the financial sector, particularly the state-owned banks.

3. The banking system in Iraq is dominated by state-ownership, where state-owned banks account for more than 90 percent of the banking system's total assets.² The state-owned banks are still encumbered with long overdue non-performing loans and have weak operational capacity, outdated systems and ineffective controls. Most of the private banks are small and limit their activities to providing transaction services to a select clientele. The state-owned banks must be reformed to enable them to better serve the market, withstand potential competition from new entrants, both domestic and foreign, and enhance their franchise and market value should their ownership structure be opened up to private interests.

II. STRATEGIC CONTEXT / DONOR COORDINATION

4. International experience has shown that a sound and efficient financial sector is essential for economic growth and development. Iraq enjoys two strong advantages: a natural endowment of oil resources and human capital, which reflects a long tradition of education, scientific and commercial skills, and entrepreneurial spirit. As the security situation has improved, the development of sound macroeconomic policies and a business environment conducive to private investment is beginning to create growth and jobs. A well-functioning financial sector is critical to promoting this growth.

5. The World Bank is working closely with the Central Bank of Iraq (CBI), the Ministry of Finance (MOF), and the Board of Supreme Audit (BSA); and in collaboration with development

¹ The total loan portfolio of banks was only US\$2.2 billion (4 percent of GDP) at end-2006, mostly in the form of overdrafts, despite the fact that credit to the private sector more than doubled in 2006. Total deposits in the banking sector were US\$12.9 billion (26 percent of GDP).

² Iraq nationalized its commercial banks in 1964. In 1974, four commercial banks were merged into one—Rafidain, which had a commercial banking monopoly in Iraq until Rasheed Bank was established. Rasheed Bank has a large domestic branch network but no foreign branches. Before the first Gulf war, Rafidain was the Arab world largest commercial bank with total assets of US\$47 billion and a branch network outside of Iraq, notably in Beirut, Cairo, Amman, Bahrain, and Sanaá.

partners, namely, the International Monetary Fund (IMF) and the US Department of Treasury. The IMF has been instrumental in pushing the restructuring process forward, holding a number of bank restructuring conferences, in which the World Bank participated.³ The US Treasury has full-time banking advisors residing in Baghdad, who continuously work with CBI and the commercial banks. To ensure effective coordination, periodic donor meetings are scheduled to help discuss progress and challenges of the reform program, and the World Bank has been arranging regular conference calls with the US Treasury and World Bank teams.

III. RATIONALE FOR BANK INVOLVEMENT

6. Enhancing the performance of the Iraqi banking system, and improving its capacity to provide efficient financial services, is crucial to creating a competitive financial system capable of enhancing macroeconomic growth and prosperity in Iraq. The proposed operation aims to support the GOI build a sound banking system that provides efficient and competitive financial services in the medium-term. The restructuring process will improve the viability of the state banks, and lead to improved accounting, reporting, and operating functions in each of the banks, and a better flow of information to the CBI.

7. The GOI has agreed with the IMF and World Bank on the program of capacity building, and institutional restructuring and reform that would need to be implemented over the medium-term to strengthen and modernize the state-owned banks. In a subsequent stage, the authorities should address the operational and financial restructuring of the state-owned specialized banks, and encourage the process of consolidation within the small and fragmented private commercial banking system. Although the non-bank segment of Iraq's financial industry—capital markets and insurance—needs to be addressed, a precondition to strengthening this segment is the resumption of effective banking operations.

8. The proposed project is consistent with Iraq's National Development Strategy, which gives priority to bank restructuring. The World Bank's program in Iraq is committed to helping Iraq use its resources more efficiently and transparently. One of the themes of the Interim Strategy Note (ISN) for Iraq for FY09-11, is to support policies and institutions that promote longer-term, broad-based, private-sector-led growth. This operation is fully consistent with this theme, and would help alleviate a major impediment to creating a more efficient financial system, and its ability, in the medium-term, to improve financial intermediation in support of real sector growth.

IV. PROPOSED PROJECT DEVELOPMENT OUTCOME

9. The key objective of the operation is to support the financial and operational restructuring of the two main state-owned commercial banks (Rafidain Bank and Rasheed Bank), help GOI streamline their role and activities in the financial sector, and provide capacity building to strengthen the supervisory and regulatory bodies of CBI. The project will also finance the audits for the state-owned specialized banks, to initiate the restructuring of the specialized banks. The World Bank will also provide technical assistance to support GOI's development of its Restructuring Action Plan.

³ IMF is providing technical assistance (TA) in the monetary and financial sector to support the implementations of the restructuring of the two commercial state-owned banks and to bolster the CBI's capacity with regard to core central bank functions, such as bank supervision, monetary policy implementations and reserve management, as well as modernizing the payments system.

10. The operation will help GOI define the mandate of the state-owned commercial banks, including their focus on mobilization of savings and payments. Done in parallel with on-going efforts to strengthen the banking sector regulatory and supervisory framework in line with international standards, these efforts will foster a more efficient financial intermediation in the medium-term. The proposed program of technical assistance will help the two largest state-owned banks (Rafidain Bank and Rasheed Bank) build their internal capabilities and develop into modern financial institutions that can one day be integrated into the private sector.

11. The proposed project aims to ensure that the two state-owned commercial banks will be well-advanced in implementing comprehensive restructuring plans based on solid analytical work, and will have developed their information technology capabilities, human resources, risk management policies, and internal controls. In addition, the supervisory and regulatory bodies of CBI will be strengthened through targeted capacity building activities. Furthermore, the project would finance audits of the state-owned specialized banks, and help the MOF put the relevant Restructuring Action Plan in place.

12. The project will be monitored by the World Bank task team, with assistance from the IMF team and US treasury advisors in Baghdad. The recapitalization and removal of sovereign debt will be monitored by reviewing the financial statements of Rafidain Bank and Rasheed Bank.

V. PROJECT DESCRIPTION

13. The project amount is US\$10 million and the project components are outlined below:

- (i) Support the GOI to develop the Banking Restructuring Action Plan;
- (ii) Assist with the institutional and operational restructuring of the two state-owned commercial banks;
- (iii) Provide technical assistance in the financial restructuring of the two state-owned commercial banks;
- (iv) Provide capacity building to strengthen the regulatory and supervisory functions of CBI; and
- (v) Finance the audits of the state-owned specialized banks.

14. The World Bank's implementation strategy will focus on early and selective engagement, flexible design and implementation, early capacity building, coordination with donors, and close monitoring and evaluation. The operation would rely on: (i) a Project Management Unit in CBI staffed by a small number of full-time Iraqi staff and consultants in Baghdad; (ii) capacity building and training of staff working on areas of banking reform identified in the operational audits; (iii) the engagement of consultants (individual and firms) to provide technical assistance and help the World Bank team monitor and supervise project implementation in Iraq; (iv) the use of the network of videoconference facilities existing in the Ministry of Planning and Development Cooperation, the CBI, and the MOF, to facilitate frequent meetings among development partners, including the IMF, US Treasury, and USAID.

VI. STATUS OF PROJECT AND TIMELINE FOR APPROVAL

15. The project has been approved by the ISRB and has been appraised by the World Bank. The project is currently scheduled for negotiations and approval by the World Bank in March 2009.