EXECUTIVE SUMMARY

The link between sound and well-developed financial systems and economic growth is a fundamental one. Empirical evidence, both in developing and advanced economies, has shown that countries with developed financial systems grow at faster rates. Efficient and prudent allocations of resources by the financial system is crucial for increasing productivity, boosting economic development, enhancing equality of opportunity, and reducing poverty. Getting the financial systems of developing countries to function more effectively in providing the full range of financial services is thus a task that will be well rewarded with economic growth.

This report takes a first look at the overall financial system of Iraq with a forward looking approach. At the outset it was agreed with Iraqi authorities that the focus of this review should be forward looking and constructive. Overall the financial sector in Iraq is underdeveloped, and is playing a limited role in financial intermediation. The banking system is still by far the most important part of the Iraqi financial system, accounting for more than 75 percent of the assets and dominated by state ownership. Non-bank financial institutions and markets are small and under-developed but have the potential to provide access to sources of finance.

Access to finance is impeded by weak financial infrastructure, which needs to be strengthened over time in all areas, including credit registry, the collateral framework, judicial systems, and accounting and auditing skills. When looking at Iraq’s financial system it is important to keep the general political economy in
mind. The difficult security situation imposes costs and constraints, the complex political situation impedes decisive policy action, governance issues linger, and the legacy of prevailing state intervention has not been fully addressed.

**Banking System**

The banking system is still by far the most important part of the financial system, accounting for more than 75 percent of the assets. Seven state banks dominate the banking system (in particular, Rafidain Bank, Trade Bank of Iraq (TBI), 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. Official figures vastly overstate assets of Rafidain Bank and Rasheed Bank (because of carryover of valuation losses equivalent to the double of GDP); staff estimates indicate that state banks account for 86 percent of bank assets and 69 percent of credits.

The banking system is 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 credits to the economy only amount to 10 percent of GDP compared to 55 percent for the MENA region. As a corollary, banks are very liquid; foreign assets and deposits at the Central Bank of Iraq (CBI) amount to 63 percent of assets.

The operations of Rafidain Bank and Rasheed Bank (the two large state banks with country wide branch network) are inefficient and the two banks suffer from the legacy of past losses as well as from carrying out of quasi fiscal operations. Reform of the two banks has been significantly delayed from what was envisaged in a 2006 Memorandum of Understanding (MOU) between the CBI and the Ministry of Finance. Several committees have been working but little progress has yet been achieved, including in the technical area of cleaning up the two banks’ balance sheets.

A World Bank project has been supporting the reform process since 2009. The reform process for Rafidain Bank and Rasheed Bank needs to be accelerated, including through the carving out of disputed items from their balance sheets and their transfer to a new asset/liability management company. More fundamentally, the authorities need to consider the relative roles they wish to assign to state banks 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. As part of this overall strategy, state banks must become subject to normal supervision by the CBI.

Private banks operate on an uneven playing field. State banks benefit from the perception of a de facto deposit guarantee and from restrictions imposed on the operations of the private banks. Government, government agencies, and state
owned enterprises are not allowed to place deposits with private banks. Nor can state-owned enterprises receive loans from private banks. Moreover, payments to the government (taxes and other payments) cannot be effected by check drawn on a private bank. 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 of them are offering a full 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 and 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. While initially some of the foreign banks are mainly oriented towards foreign companies doing business in oil and related activities, over time they should help improve the overall banking climate and help stimulate the development of the financial sector.

Profitability of banks is in general 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 private banks are strong, except for three banks. Prudential and performance indicators for Islamic and conventional private banks are broadly similar, but Islamic banks fund themselves more from capital and give a larger share of long term loans.

There is concern among some market participants and observers that banks may be weaker than they appear as accounting and auditing standards are lax and banking supervision is not in all cases fully effective. Nevertheless, most banks appear to be well capitalized, and with a continuous strengthening of banking supervision and financial infrastructure and a leveling of the playing field, the majority of private banks should be able to continue to grow and improve and gradually provide the financial underpinning of stronger non-oil growth. The planned gradual increase in minimum capital requirements will help promote consolidation and further strengthen the private banks. State banks will also need to increase capital to help level the playing field.

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, if a risky assumption is made as to the actual level of capital in Rafidain Bank and Rasheed Bank.

As noted above, bank credit is relatively low and access to other forms of finance also needs improvement. A USAID project team has estimated 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 to GDP to the average level for MENA countries of 55 percent will require an increase in credit of ID 45 trillion. The planned increase in bank capital levels will be sufficient to support such a lending level. However, depending on whether credit growth does not outpace banks’ risk management skills, nor the capacity of the CBI to supervise banks’ rapid growth, such an increase in credit within a short time typically bears the risk that asset quality deteriorates.

Weak financial infrastructure is a clear impediment to access to finance in Iraq. Actions are needed in all areas, including credit registry, the collateral framework, judicial systems, and accounting and auditing skills. Improving the accounting and auditing skills, and over time moving to international standards, are particularly important, both to help ensure the transparency of banks and to allow banks to identify creditworthy clients. More reliable accounts are also key for better quality share issuance prospectuses, and for the development of reliable financial media. Iraq was last among Arab countries in the survey of “Doing Business in the Arab World 2011” and the authorities must undertake a concerted effort to improve the business environment and to strengthen the real economy through revitalization and privatization of the state-owned enterprises.

The Iraqi payments system is relatively well developed, representing in part significant technical support from foreign donors. A real time gross settlement (RTGS) system 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.

Banking Supervision

The Iraqi system of banking laws and regulations provides a workable framework for the exercise of banking supervision, provided the 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 help further align the system to international standards.
However, for the CBI to be able to fully deploy effective supervision, three main conditions need to be met: (i) the political will to let the CBI perform its tasks without interference also with regard to state owned banks, using the laws, regulations and its professional judgment, (ii) assurance that the state owned banks which hold by far the majority of banking system assets, 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) the CBI has the necessary resources—in terms of quantity and quality—to take on the supervision of these large institutions with their many branches.

For optimal effectiveness of the current set of rules and regulations, enforcement needs to be strengthened, and banks rated three under the CAMELS system need to be carefully monitored to prevent further slippage in safety and soundness in the current environment in Iraq. Banks’ financial and prudential information needs to become more reliable and more rapidly accessible, through introduction of fully 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, strong 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 under-developed but has potential to provide issuers with access to sources of permanent and long term capital via the issuance of equity and corporate bonds to institutional and retail investors, domestic and foreign. It is currently at a crucial stage of its development. Activating the privatization program in a way which would 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 the latter as there is no “risk free” yield curve off which to price corporate bond issues.
Capital market development requires improvements in all of the necessary underpinnings of a market in which issuers and investors can have confidence. These include the 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 change to achieve these ends had been discussed since 2008 and steps should now be taken to implement it. This report sets out some amendments which would provide enhancements to the current draft permanent 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, competences 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 Company 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.

This report sets out and prioritizes thirteen recommendations for change. They include legislative and regulatory improvements, changes to market infrastructure, the development of new capital market based products to attract investors and measure to expand the size and depth of the capital market.

**Insurance and Pensions Sectors**

The insurance sector in Iraq is dominated by the 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, but 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 now should be for to make the supervisor operational so that its existence is made known to the market participants and it commences the supervisory activity the present legislation allows it to conduct.
The present insurance legislation should also be strengthened so it is brought in compliance with the international best practice standards. It is particularly important that the new legislation provides the supervisor with the needed 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 presently going through a transition period with the combination of the existing pension system into one unified pension fund. A law was passed to allow for this unification into one pension fund. The World Bank is helping out through the PRISTA project to make this unified pension fund operational. The present organization of the pension funds does not provide proper protection of the participants’ fund and does not include requirements to supervision of the pension fund. It is very important that these elements are incorporated now, because it will be very difficult to establish these protections once the new fund has been established.

**Summary of Key Recommendations**

While work should commence on a broad range of issues, some key decisions need to be taken immediately, while others may be implemented over the medium term. Key issues to be addressed up front are the role of state banks and the creation of a level playing field for all banks. This will need to be followed by the early adoption of the proposed permanent Securities Law and steps to turn the insurance Diwan into an effective supervisor. Supporting ongoing efforts will be needed to address financial sector infrastructure, including supervision, credit registry, collateral framework, judicial systems, and accounting and auditing frameworks.

A crucial step, also to signal seriousness of intent, is to clean up the balance sheet of Rafidain Bank and Rasheed Bank, which has been under discussion since 2006. Since more time may be required to clarify some of the disputed items on the balance sheet, the best approach will be to transfer disputed assets and liabilities of the two banks to a newly created asset/liability management company to permit the slimmed down Rafidain Bank and Rasheed Bank to focus on moving forward with their operational restructuring. The latter process is well formulated in the 2006 memorandum of understanding between the Ministry of Finance and the Central Bank of Iraq and should be carried out over the next two years. Once the balance sheet is cleaned up, the capital of the two banks should gradually be brought up to the level prevailing for private banks by June 2013. Once the reform of Rafidain Bank and Rasheed Bank is well under way, the authorities should consider more generally the role of state banks in the economy, including that of ITB and the four smaller sectoral banks, with a view to eventual liberalization.

As noted above, private banks operate on an uneven playing field. An immediate priority should be to announce the removal of all impediments for private banks
in doing business with the government and state owned enterprises. Given some concerns over the strength of private banks, some elements, such as the size of letters of credits, could be phased in over a period of two years (but preannounced) to permit enhancement of the effectiveness of banking supervision to take hold as well as some consolidation of the banking system following the increase in minimum capital levels. It is clear that this potential expansion of private banks’ business opportunities entails keen vigilance on the part of the banking supervision department of the CBI to ensure the safety and soundness of the private banks.

A permanent Securities Law has been under discussion for several years. The government need to urgently conclude these discussions, after also considering the recommendations contained in this report. The Law should then be presented to Parliament for speedy passage. Early passage of the Law is required to allow the ISC to enhance its role in developing capital markets.

The insurance market is at an early stage of development. Nevertheless it is urgent that the Insurance Diwan be given the human resources to allow it to take on its assigned role of regulating the insurance market. As noted in the report, the insurance law will need to be amended to allow the introduction of internationally recognized principles of supervision.

Carrying out the review has posed a number of unique challenges. Access to key officials and market participants within Iraq was severely limited because of the security conditions and the team therefore had limited possibilities to assess first hand actual implementation and enforcement of rules and regulations. Moreover, due to the recent introduction of many of the prudential regulations, there is little track record of compliance and enforcement. Nevertheless, in spite of these caveats, this assessment point clearly to a number of key issues that need to be addressed to underpin the development of Iraq’s financial system.

The report comes up with key recommendations some of which are short term, in the sense that they should be initiated immediately. Others will be ongoing and may only be fully realized in the medium term. All these aim at enhancing the performance and soundness of the financial sector in Iraq, and ensuring that it plays a key role in financial intermediation and overall economic growth.