



PROMOTING FINANCIAL INCLUSION FOR GROWTH AND DEVELOPMENT IN IRAQ

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Introduction - Inclusive Financial Sector Development a Key Priority for Iraq²: A well-functioning financial sector is critical for efficient resource allocation leading to increased productivity, greater investment, and higher overall levels of economic growth.³ This is particularly critical in Iraq, where years of political instability and violence have impeded the development of a robust private sector, decimated infrastructure and institutions, and caused serious employment challenges. Overall unemployment stands at 11.7%, but is much higher for younger adults (16.9%) and women (35.7%) (World Bank, 2013). Labor force participation is very low, and most Iraqis work for the government or in the informal sector.

Financial inclusion - the proportion of individuals with access to formal financial services including credit, savings, and insurance services - is critical for improving household welfare by spurring economic activity and helping manage economic shocks.



Participants at the Workshop on the Iraqi Financial Sector Legal and Regulatory Framework Workshop in Abu Dhabi (December 2013) - Photo by Peter McConaghy

Financial inclusion also positively impacts on macroeconomic stability. The extent of financial intermediation causally impacts growth, mostly through lower transaction costs and better distribution of capital and risk across the economy.⁴ Microfinance has in recent years become an important mechanism to promote financial inclusion and economic development in Iraq. Microfinance Institutions (MFIs) have emerged as credible sources of financing for low income households and microenterprises, both underserved by conventional banks. As of December 2012, 12 MFIs were serving 98,776 active clients (1.3% of the poor; 21% were women). Annual growth rates in outstanding portfolio and number of clients in 2012 were 17% and 14% respectively. Yet, critical regulatory and legal issues inhibit expansion.

A Snapshot of Iraq's Financial Sector: Iraq's financial sector is bank-dominated and under-

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² This Quick Note was informed by a Workshop on the Legal and Regulatory Framework for Iraq hosted by the World Bank, CGAP, and the Arab Monetary Fund on 12.9.2014 in Abu Dhabi. It also draws on the findings of a joint WB-CGAP Report on the Legal and Regulatory Framework for Microfinance in Iraq, prepared by Kate Lauer, Nadine Chehade, Alaa Abbassi and Teymour Abdel Aziz.

³ For empirical data on the links between financial sector development and growth, see Demirgüç-Kunt, Asli, and Ross Levine. 2008. "Finance, Financial Sector Policies, and Long-Run Growth." World Bank, Washington, DC.

⁴ For a full discussion on the links between financial inclusion and development, see: 2013. "Financial Inclusion: Global Financial Development Report." World Bank, Washington, DC.

developed compared to regional peers. The banking sector has over 75% of the financial system's assets, with an asset to GDP ratio of 73%. This is much lower than the MENA ratio of 130%. Seven state-owned banks dominate and hold 86% of all bank assets. There are 47 private banks registered with the CBI, 15 of which have foreign partners, of which nine are Islamic. Non-bank financial institutions are small and underdeveloped and Iraq's stock market is nascent, with a total market of around US \$3 billion (IQD 3.5 trillion).

Iraq's financial system is not very supportive of Micro, Small, and Medium-Sized Enterprises (MSMEs). Nearly half of firms surveyed in a 2012 World Bank Investment Climate Assessment (ICA) reported great difficulty in obtaining financing and less than 7% reported receiving a loan. The microfinance sector can be an important provider of financial services to MSMEs underserved by the conventional financial sector. A 2005 ILO estimated the number of registered SMEs with three or more employees at 622,000, self-employed entrepreneurs at 719,000, and an estimated one million unregistered MSMEs.

The Microfinance Landscape in Iraq: The microfinance sector has grown significantly over the past ten years, mainly due to extensive support from donor (notably USAID) funding and scaling-up of NGO MFIs. The sector includes 12 NGO-MFIs operating in all 18 provinces, with an outstanding portfolio of US \$150 million (IQD 174.6 billion), equivalent to 0.25% of banking sector assets (See Table 1). The outstanding portfolio balance grew 17% in 2012, after growing 48% in 2009. In addition to NGO MFIs, the Ministry of Labor and Social Affairs began microfinance programs in 2007, though the programs used subsidized interest rates. With regards to penetration as a percentage of the overall population, the Iraqi microfinance sector remains one of the smallest and least developed in MENA. The sector's growth is a product of the relatively high average loan size (US \$1,500) compared to its client outreach levels.

Supply of Microfinance: Financial services to the poor are mostly microcredit. Two MFIs (Vitas and Al Thiqa) manage 56% of the sector's

overall portfolio and 44% of the client base. MFIs do not offer savings, insurance, or payments and transfer services. Despite the difficult environment, Iraqi MFIs have maintained a good, if deteriorating, portfolio quality. Non-performing loans over 30 days were at 2.7% as of December 2012.

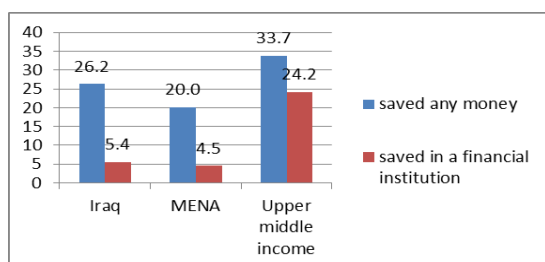
Demand for Microfinance: Access to financial services for households and microenterprises is very low in Iraq by regional and income group standards. According to Global Findex, in 2011 only an estimated 10.6% of the adult population (7.5% women) in Iraq had access to an account at a formal financial institution. This is the third lowest in MENA, and much lower than the regional (17.7%) and income group average (57.2%). Only 5.14% of small and 9.36% of medium-sized firms report a loan, compared to 23.53% of large enterprises (World Bank ICA 2012). While 26% of adults reported savings in the past year, only a fifth of this amount went to formal financial institutions. Similarly, less than 15% of adults who borrowed did so through formal financial institutions (figure 1).

Table 1: MFIs AND COMMERCIAL BANKS IN IRAQ as of 2012

Indicators	MFIs	Banks
Number	12 MFIs	State (7); private banks(47)
Number of Branches	109 outlets	State (391); private banks (383) For SMEs about
Loan Size	US\$ 500 - 25,000	US\$ 15,000 at disbursement
Repayment Period	12 months	Typically < 2 years
Collateral Requirements	1) Government Employee guarantees 2) Solidarity Group: peer to peer	Usually physical collateral if > \$10-15K
Services Offered	1) MSME Loans 2) Agri-business Loans 3) Housing Loans 4) Trade Loans 5) Taxi Loans	Overdraft, trade finance, deposits and money transfers, loans and guarantees
Loan Processing Time	2-3 Days	Highly variable, usually 30 to 60 days,

Source: USAID Iraq's State of Microfinance 2012.

Figure 1: Savings Patterns in Iraq



Source: Findex (2011)

The Legal and Regulatory Framework Governing Microfinance in Iraq: The microfinance sector is regulated by multiple laws and supervisors each with varying degrees of control. NGO MFIs are regulated by the NGO directorate under the NGO law of 2010, which requires both national and international NGOs to register and conform to rules and requirements. There is a separate NGO Law approved by the Iraqi Kurdistan Region's Parliament in 2011. Although NGO MFIs are registered under the NGO Law, the CBI arguably has the right to regulate them as financial institutions.

There are a number of laws supporting small businesses in Iraq which affect microfinance. In 2012, parliament passed the Support of Small Income-Generating Projects Law, which allows government to provide interest-free loans and tax exemptions to small businesses (no more than 10 employees). Similarly, the SME finance company ordinance of 2010 explicitly permits commercial companies (SME Finance Companies) to engage in lending activities for SMEs, which can include micro-enterprises. SME finance companies are not permitted to engage in deposit-taking. Despite this Ordinance, no companies have to date been created. It is not clear whether this is due to regulatory barriers, other bureaucratic issues, or business viability issues.

Strategic Issues in the Iraqi Microfinance Sector:

Funding: Declines in sectoral growth can in part be explained by funding constraints facing NGO MFIs. Although most MFIs have historically relied on grants, there have been no new grants to the sector since September 2012.

Other sources of funding are limited. NGOs cannot raise equity or take deposits. Despite the absence of restrictions on fund transfers into and out of Iraq, international microfinance investors are not active in the country, with the exception of OPIC. There appear to be few local investors or banks willing to lend to MFIs.

Transformation of NGOs to For-Profits: One possible solution to attract funding is through the conversion of MFIs from NGOs to for-profit entities. There is currently a lack of clarity regarding how an NGO-MFI can "transform" into either an SME Finance Company or another type of for-profit firm. Historically, the NGO Directorate has asserted that NGO MFIs are not permitted to transfer assets to a company in exchange for assets of equivalent value or for shares, although this policy is subject to ongoing analysis and rethinking. Legally the NGO law does not prohibit an NGO from selling its loan portfolio to a company provided that proceeds of the sale are used in accordance with the NGO's mission and no personal gain accrues from the sale to NGO employees. Global experience demonstrates that these types of transformations are critical to access broader funding sources and to offer additional services (deposits, transfers) which may be outside of an NGO's legal purview.

The Regulatory and Supervisory Framework: The regulatory and supervisory frameworks for the microfinance sector in Iraq could be clarified and strengthened. While the CBI under the Central Bank Law has the authority to regulate and supervise NGO MFIs as financial institutions, NGO MFIs are currently registered and supervised by the NGO directorate under the NGO law. The NGO directorate may not be best placed to regulate and supervise financial institutions. In addition, there is a lack of a level playing field due to differing rules applying to NGOs in Iraq, Kurdistan, and SMEs subject to the Finance Companies ordinance.

Consumer Protection: Iraq is without specific consumer protection regulation for financial services. While banks and financial institutions are subject to secrecy and privacy provisions under the banking law, the NGO law does not contain similar provisions. The 12 MFIs have signed a code of conduct pledging commitment

to consumer protection, though the code is unenforceable and has no legal basis.

Strategic Recommendations to Develop Microfinance in Iraq:

The microfinance sector in Iraq has contributed significantly to economic development by offering low-income individuals access to quality financial services not offered by commercial players. Outreach and impact, however, remain significantly below market potential. There is a large unmet demand for financial services (credit, savings accounts, payment services) by households and MSMEs. There are also critical market and non-market (e.g. regulatory and enabling environment) bottlenecks that must be addressed to expand financial inclusion in Iraq.

Short-Term Recommendations:

1. Harmonize rules applicable to NGO MFIs (in Iraq and in the KRG) including disclosure, loan provisioning, as well as governance requirements
2. Determine the appropriate government agency to regulate and supervise NGO MFIs. If possible, place NGO MFIs under the responsibility of the CBI. The latter may be better placed to understand linkages between different financial institutions and monitor non-prudential regulations (e.g., proper disclosure of interest rates and fees to clients, consumer protection, etc.). CBI regulation can help ensure a level playing field amongst all financial service providers
3. Amend the SME Finance Companies Ordinance by, inter alia, adopting “fit and proper” capital requirements, relaxing limitations on bank debt (currently set at 300% of capital), and modifying local and foreign donation restrictions.

Medium-Term Recommendations:

1. Conduct a study to assess current demand among poor and low-income populations for services including savings, payments and transfers, and insurance.

2. Clarify the legal process by which the transformation of NGO MFIs to for-profit entities can take place.
3. Adopt financial consumer protection rules applicable to all financial service providers.
4. Establish a comprehensive credit information sharing system. A well run credit bureau can provide financial institutions with inexpensive means of assessing the creditworthiness of borrowers and bring down the cost of lending.
5. Encourage bank downscaling, particularly with respect to banks using agents (e.g. individuals, legal entities).
6. Shift government from provider to facilitator through gradually eliminating direct funding schemes that provide below-market or interest-free loans. Such government intervention creates market distortion due to unfair competition.
7. Permit MFIs to be agents of insurance companies.
8. Establish a fast track process for loan recovery. Summary procedures should be introduced in cases of simple contract enforcement/debt collection.
9. Adopt the appropriate legal framework for leasing and secured transactions. Financial leasing and the use of various movable collateral can greatly increase private sector access to credit in Iraq and reduce its cost.

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