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IRAQ PRIVATE SECTOR GROWTH AND EMPLOYMENT GENERATION

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PRIVATE BANKS IN IRAQ 2006



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By David Munro
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The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

Introduction

This paper updates information contained in the author's "Survey of the Iraqi Banking System" written in November, 2003. The current study, however, does not deal with the public sector banks, but instead concentrates on those in the private sector, their management and financial results over the three-year period 2003 – 2005. Financial information evaluated is limited to balance sheet entries, as due to uncertain income-recognition standards and a lack of sufficient disclosure regarding asset quality, it is difficult to assess with any degree of certainty income statement entries. As nearly all banks claim to be profitable, and, owing to the inadequacy of loan loss provisions and reserves against volatile investment portfolios in a market that has been in steady decline, the analyst is not inclined to take at face value results reported in bank annual reports.¹

We were able to obtain annual reports for most of the 23 operating private banks. Of the total, Ashour Bank, Kurdistan Bank, Dijlah wa Furat Bank (Tigris and Euphrates Bank) and Mansour Bank have not completed a year of operations. Dar as-Salaam and Commercial Banks have yet to finalize annual reports for 2005.

Background

As of October, 2006, there were 25 private banks licensed by the Central Bank in the Republic of Iraq, with 23 in operation. In late 2003, there were 18 private banks licensed and operating, most of them having opened their doors in the early 1990s. At the time the earlier study was written, the expectation was that as the situation in Iraq stabilized, and as foreign investment in the banking sector took place, there would be a winnowing out of the weaker banks, and, perhaps, a series of mergers to create larger, more competitive private banks. In fact, despite a certain degree of post-conflict euphoria, foreign investment in the banking sector has been limited to seven banks, and no new investments have been made since 2005. The seven banks with foreign shareholding are: Commercial Bank, 49% owned by al-Ahli United Bank of Bahrain (through an Iraqi holding company); Bank of Baghdad, 49% owned by the United Gulf Bank of Bahrain; National Bank of Iraq, 49% owned by the Export and Finance Bank of Jordan (renamed the "Capitol Bank"); Credit Bank of Iraq, 75% owned by the National Bank of Kuwait and 10% by the International Finance Corporation (IFC); Dar as-Salaam Bank, 70% owned by Hongkong and Shanghai Banking Corporation (HSBC); Economy Bank, 49% held by the A'ayan Company of Kuwait; Mansour Bank, 60% owned by the National Bank of Qatar.

No mergers have taken place, and although the lower tier private banks remain small, they have managed to increase capital to the ID 10 billion (\$5 million) requirement

¹ The Iraq Stock Exchange (ISX) reports a fall in index prices from nearly 20.0 in September, 2003, to around 5.0 in October, 2006. Average volume traded has fallen from around 5.5 billion shares to 1 billion in the same period (As many shares are priced at ID 1, equivalent to \$.000685, the actual amounts being traded are relatively small). Source: ISX website.

mandated by the new banking law promulgated in 2003 (with the capital requirement in place effective the end of March, 2005).

In addition to the operating private banks, three banks are setting up operations – the Tigris and Euphrates Bank, the National Islamic Bank, and the Bank Audi (Lebanon) branch in Arbil, and there are 17 applications pending at the Central Bank for new banking licenses (See Appendix I for a list of these banks).

Two foreign banks have been licensed by the Central Bank – T.C. Ziraat Bankasi of Turkey (the state agricultural bank) and the Arab Banking Corporation, the latter of which maintains an office in Baghdad but is not engaged in retail banking operations.

Preliminary approval has been granted by the Central Bank for the following banks to be issued licenses: Bank Melli Iran (the national bank of Iran), Al-Ahli United Bank (Bahrain), the Commercial Bank of Kuwait, the Housing Bank for Trade and Finance (Jordan), and Arab Bank Ltd. (Jordan). Given the present security situation in Iraq, however, it is unlikely that these banks will pursue opening branches at the moment.

In Kurdistan, the Kurdistan Investment Bank is operational (we believe it is licensed to operate in Kurdistan by local authorities), and Bank Audi and Byblos Bank (of Lebanon) are slated to open soon, in addition to the Intercontinental Bank.

Relative Size of the Banks

Al-Warka' Bank is the largest private bank in Iraq, ranked by Total Assets, with over \$230,000,000, as of December 31, 2005. Middle East Bank is second with \$219,000,000 and Bank of Baghdad third with \$218,000,000. Credit Bank and Dar as-Salaam follow; thereafter a rather sharp drop-off occurs, with banks ranging from \$18 million on the low end to \$107 million on the high end.

Considerable growth has occurred in the total assets of the private banking system, particularly over the year 2004 -2005, which saw an average increase of 254% and a system-wide jump of 146%. As will be seen below, however, increases in 'real' lending (after inflation) were not so pronounced.

Earning Assets

As was the case in 2003, Earning Assets (Loans and Advances plus Investments) do not comprise even 50% of most of the banks surveyed balance sheets. For the fifteen reporting banks, the ratio Earning Assets/Total Assets averaged only 36.2%. A comparable ratio for Western banks would be in the neighborhood of 70% - or higher.

In addition, Loans comprise just over 70% of Earning Assets, with the remainder in short-term investments (excluding bank deposits).

Four of reporting banks display Earning Assets/Total Asset ratios of between 3% and 13% - an extremely meager showing. At the other extreme, two banks exhibit ratios of 61% and 63%; in addition, their composition of Earning Assets is heavily weighted towards loans and advances rather than investments.

Some of the banks with healthier ratios are actually engaged in very little lending when compared with other deployments of assets (short-term investments). One leading bank exhibits a Loans/Earning Assets ratio of 14.3%. with an overall Earning Assets/Total Assets ratio of 58.3%.

Although lending as a percentage of Earning Assets (and Total Assets) varies greatly among the banks, virtually all private banks exhibit considerable balance sheet growth over the past three years. The average growth in Loans and Advances for 15 reporting banks 2004-2005 was 111.9%, for the period 2003-2004, 283.5% (11 reporting banks).

Nevertheless, correcting for inflation of 46.9% 2003 – 2004 and 31.7% 2004 – 2005² reduces growth between 2004 – 2005, and eliminates it altogether for three of the banks. Two banks show before-inflation decreases in loans outstanding.

While we do not have figures for 2006, it is our understanding that credit outstandings decreased over end-of-year 2005 levels.

One of the policy recommendations of the Izdihar project is that the Central Bank of Iraq encourage private banks to raise their Earning Assets/Total Assets ratios to 50%, and that this increase be made in the Loans and Advances component of the ratio. Were banks to increase lending efforts accordingly, an additional \$294 million could be made (using year-end 2005 figures as a base). The results of expanded bank capitalization and continuing high liquidity manifest themselves most noticeably in the increase in deposits at the Central Bank and other banks, rather than an increase in lending. Incentives

² Central Bank of Iraq website.

and/or moral suasion regarding SME lending and an altered interest rate policy could help redress this situation.

Another important factor, of course, is the local real estate market, which experienced a post-war boom that saw prices increase more than 1,000%. As Iraqi bank lending historically has been largely secured by real estate, the borrowing capacity of local businesses that owned their own premises suddenly grew exponentially. However, the market contracted in 2004, as investors shied away from the increasingly insecure Iraqi business environment. By 2005 - 2006, the exodus of Iraqis and contraction of the real estate market, plus the increasing difficulty in perfecting liens against real property (given the deteriorated security situation) had a chilling effect on traditional bank lending.

Table 1: Loan Breakdown 2005³

Name of Bank	Overdrafts	Overdrafts	S/T Loans	S/T Loans	Total	Other
	Businesses	Persons	Businesses	Persons	S/T Loans	
Investment						
Commercial	2.0%	19.9%	0.0%	72.8%	72.8%	5.3%
United	23.1%	18.2%	N/A	N/A	55.4%	3.3%
Al-Warka'	0.7%	43.7%	14.0%	34.1%	48.1%	7.5%
National	56.4%	20.3%	4.6%	16.4%	21.0%	2.3%
Babel	6.9%	35.1%	0.0%	54.5%	54.5%	3.5%
Middle East	0.4%	4.5%	12.1%	58.7%	84.3%	10.8%
Mosul	7.2%	31.5%	10.3%	42.6%	52.9%	8.4%
North	0.0%	43.5%	1.5%	39.7%	41.2%	15.3%
Sumer	3.6%	38.0%	3.4%	14.5%	46.2%	12.2%
Baghdad	0.9%	6.9%	0.0%	4.3%	4.3%	87.9% *
Basrah	0.4%	11.7%	1.0%	77.6%	78.6%	9.3%
Credit	-8.4%	11.7%	0.0%	61.0%	61.0%	35.7% **
	23.8%	18.9%	N/A	N/A	57.2%	0.1%

A number of reporting banks provide in their annual reports the loan breakdown cited above: Overdrafts and short-term loans, to individuals and to businesses. The latter distinction is largely meaningless, however, as no bank makes consumer loans. All loans are for "business purposes," but it is easier to process loans to individuals particularly if the collateral is in the individuals' names.

The former distinction, however, is of interest as we wish to broker an SME lending industry in Iraq. Traditionally, all lending (other than discounted bills and letters of guarantee – and these latter are contingent liabilities) was essentially to traders or

³ *Sumer Bank's loan portfolio is comprised almost entirely of bills discounted. **Basrah Bank shows a negative overdraft balance for businesses.

merchants on a secured overdraft basis. SME loans, of course, are in specific amounts for specific tenors, and feature monthly repayments. Thus, the use of “short-term loans” rather than overdrafts is preferable, even if current practice among Iraqi banks calls for “bullet” repayments (one repayment), rather than monthly installments.

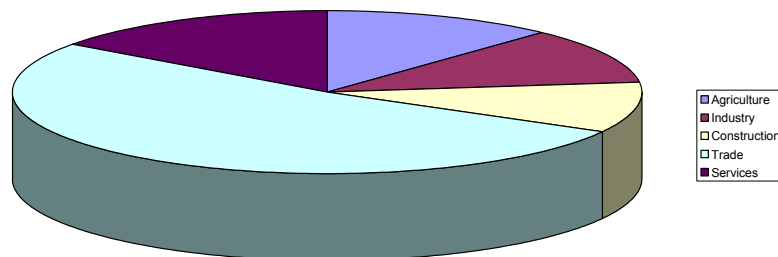
One thrust of Izdihar bank training efforts over the past two years has been to stress the advisability of using loans for specific purposes and tenors with monthly repayments as the preferred lending structure. Indeed, the Iraq Company for Bank Guarantees (ICBG) program as currently configured, requires that eligible loans be of this type. Advantages to the bank include matching of repayments to cash flow from operations, and relative ease in monitoring borrower performance: Monthly repayments give the bank an early warning (in the form of a missed or delayed installment) should the borrower begin to experience difficulties.

Investment, Commercial, National, Babel, Baghdad, Basrah and Credit banks use the short-term loan structure for over 50% of their credits. One of the largest banks relies heavily on overdraft financing (76%). Overdrafts, or their more structured cousin, revolving lines of credit, are of greater convenience to traders than straight loans. However, they are much more difficult to police and monitor, and can easily lapse into “evergreens” – facilities that are never paid off in full and that come to resemble permanent working capital injections rather than loans.

Sectoral Loan Breakdown

Only two of the banks surveyed provided an industry breakdown of their loan portfolios, Gulf and National. Gulf’s breakdown (for 2004) shows sectoral distribution as follows:

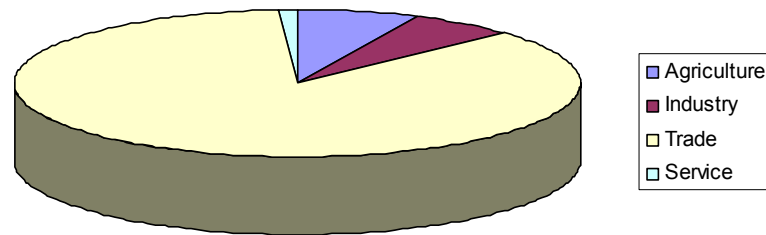
Chart 1: Gulf Bank Sectoral Loan Distribution 2004



Agriculture 12%, Industry 11%, Construction 10%, Trade 52%, Services 15%

The majority of credits are to the Trade sector, probably in the form of overdraft facilities (although we do not have a breakdown by loan structure for Gulf Bank).

Chart 2: National Bank's Sectoral Loan Distribution 2005



Agriculture 7%, Industry 6%, Trade 86%, Service 1%

In the case of National Bank, 86% of credits are to trading companies, with a high percentage of loans represented by overdrafts.

We may take these breakdowns as indicative of the banking industry as a whole: Primary lending activities involve traders and merchants, and – as we have seen in Table 1, above - overdraft financing plays a prominent role. In this regard, one constant theme of the Izdihar training courses has been the advisability of diversifying lending portfolios by sector and subsector. Concentrations in the trade sector (or any sector), accordingly, are to be avoided.

Reserves and Provisions

Prior to 2006, and despite promulgation of a new banking law in 2003, the Central Bank of Iraq (CBI) had not issued new regulations governing loan classification and provisioning. Regulations required that banks establish a general reserve of no less than 2% against the loan portfolio (as per the Ministry of Trade), plus a loan loss provision of between 2% and 5%. In addition, banks were to maintain a Tier 1 Capital/Risk Adjusted Assets ratio of not less than 12%.

Effective 2006, a new regulation was circulated, adhering to Basel requirements: Classification henceforth is to be as follows:

<i>Classification</i>	<i>Days Past Due</i>
Past Due	1-89 days
Substandard	90 - 179 days
Doubtful	180 – 359 days
Loss	360 days +

Reserves required are:

<i>Classification</i>	<i>Amount of Reserve</i>
Current	2%
Past Due	2.5% – 5%
Substandard	20%
Doubtful	50%
Loss	100%

This new regulation requires that loans be classified monthly. A further stipulation is that loans past due 90 days or more may not be deemed earning assets (Interest may be accrued and credited to a suspense account. It may not be recognized as income).

These regulations are in concert with international practice and the Basel accord, and mark a great improvement over the *status quo ante* in which some banks had little more than the required 2% general reserve and a 2% provision against loan portfolios that had been impaired during the war period and its immediate aftermath.

No recommendations or requirements were promulgated with respect to writing off loans, however, and one would hope the CBI will address this oversight in due course.

Notwithstanding the previously rather lax monitoring regime, many banks reserved beyond the 2% general provision and the 2-4% doubtful debt provisions required. Creation of these reserves was governed by internal policies, not by CBI regulations. It is often difficult to locate in annual reports the precise amount of loan loss provisions, as they may appear in several entries under such rubrics as “Accounts Payable” or “Other Debtors.” The analyst would wish to see the loan portfolio carried on the Asset side as a gross amount, minus the reserve, and a net figure, with the corresponding “Loan Loss Provision” appearing on the Liability side of the balance sheet, and an explanatory note outlining changes in the provision over the reporting period.

As the CBI did not adopt the prudential regulations recommended by the Coalition Provisional Authority (CPA), there is no reserve requirement against overdrafts.

Regarding the treatment of overdrafts, Iraqi banks should distinguish between overdrafts under approved lines of credit, and “casual” overdrafts resulting from the payment approval for individual checks not covered by a line of credit. Overdrafts falling within an approved line, with a governing loan agreement, and subject to conditions (such as an annual or semi-annual paydown or “cleanup”) are greatly preferable to the casual type of overdrafts often encountered, which can soon transmogrify into equity positions rather than loans. Furthermore, absent clean-up provisions, deciding whether or not an overdrawn current account is a “performing” loan or not is highly subjective, often based upon such largely irrelevant indicators as “turnover” – activity – in the account, rather than actual paydown. “Performing,” like “beauty,” is in the eye of the beholder. Debiting interest owed to an already overdrawn account is a time-honored method of recognizing fictitious income and inflating revenues recorded on the income statement.

Past Dues

Past Dues can be found among the entries in the Other Debtors account: It is necessary to consult the notes to the financial statements to locate the components of Other Debtors. However, amounts contained therein are calculated prior to the promulgation of the new CBI regulations on classification of loans and provision of reserves. Accordingly, and unless there is specific mention of a reserve against overdrafts, no provision is made for doubtful debts falling within this category. Furthermore, only past due installments are included in “Past Dues;” in other words, no provision is made against the outstanding amount of principal not currently due.

Of the nineteen banks for which we have data, nine show provisions in excess of past dues. The remaining ten banks have provisioned amounts smaller than identified past dues.

Eight banks show past dues in excess of 10% of portfolio; of these, only one has provisions in excess of past dues.

Related Party Lending

The new CBI regulations limit insider lending as follows:

<i>Group</i>	<i>Percent of Capital</i>
Members of the Board of Directors, staff, large shareholders	5%

Companies or groups of family members of Board members, staff or large shareholders	25%
Individual businesses or family members of Board members, staff or large shareholders	10%
In aggregate, lending to individuals or groups of insiders as defined above	50%

All insider lending is to be reported to the CBI.

The private banks are essentially family banks: Most have as shareholders members of more than one family, but since inception these banks –as is often the case throughout the developing world – were meant to be the financing arms for the family businesses of prominent traders. The extent to which insider lending takes place is unknown, but must be assumed to be material.

One means of attempting to ascertain (if not limit) the scope of insider lending would be to require banks to report not simply maximum lending to borrowers, but maximum exposure as well. This latter figure would include amounts guaranteed to third parties, as well as other forms of indirect exposure and/or lending (letters of guarantee outstanding, for example). In addition, it should be required that maximum exposure to groups of borrowers (related parties) be shown.

Periodic Reporting to the Central Bank

Central Bank regulations require that banks submit trial balances on the 15th of each month, and every six months. The former are to include balances in current accounts and balances in overdraft accounts. The latter report is to include names of account-holders.⁴

In addition, credit facilities made to insiders must be reported on a monthly basis.

Various Regulations

CBI regulations covering various aspects of account and loan management, include:

1. Protection of confidentiality of account holders;
2. Bank officers signing corrections made to reports;
3. Safeguarding of bank official stamps;
4. Powers of Attorney;
5. The death of account holders;
6. Approval for payment of checks that overdraw accounts;
7. Procedures for pledging deposits;

⁴ Central Bank of Iraq, Center for Banking Studies, “Internal Bank Operations, Part I,” pp 26-27.

8. The design of checks.

One is struck by the summary nature and seeming haphazardness/serial unrelatedness of the regulations, as well as the many aspects of bank operations that go unmentioned (in addition to a considerable amount of generality; eg, bank confidentiality – the regulation specifies that account holders and their account balances may not be disclosed only – no mention is made of borrowers, no mention is made of what policies and procedures govern disclosure to authorities, etc). There is a need for a considerably expanded prudential regulation regime.

Rates of Interest on Loans

Since 2004, Iraqi banks have been free to set their own interest rates on loans (previously rates had been set by the CBI). A survey conducted by the Izdihar SME Development/Bank Lending component in September, 2006, with nine banks responding, yielded the following results:

<u>Bank</u>	<u>Rate Charged on One-Year Iraqi Dinar (ID) Loans</u>
Gulf	16%
Ashour	14%
Mosul	14%
Middle East	14%
North	12%
Investment	15%
Baghdad	12%
Dar as-Salaam	15%
Commercial	17%

For the same month, the CBI reported that the average rate charged on one-year ID loans was 14.6%.⁵ As banks do not discriminate among borrowers on the basis of perceived risk, these rates are applied across the board to all loans. The results show a considerable range, although five of the nine charge 14-15%.

At the same time, deposit rates paid by banks averaged 7.3% for September. When you add to this the fact that a considerable amount of the funds on deposit with the private banks are in non-interest-bearing accounts, it is evident that the banks enjoy a healthy spread over cost of funds.

From the standpoint of developing an SME lending industry in Iraq, the rates CBI pays on deposit placements are not helpful: The CBI currently pays 11% on 14-day deposits, and 12% for 30-day deposits.⁶ Faced with a market which pays on average 14.6% on short-term loans before reserves (and virtually all lending is for one-year tenors

⁵ CBI website.

⁶ The policy rate has recently been raised to 20%, raising the spread to 13%.

or less), it is no wonder that banks prefer to place their funds on deposit with the Central Bank, and pocket the spread of 6-9% without incurring any risk whatsoever.

Profitability Consciousness

Infrequency of financial statement preparation underscores a lack of awareness and of concern about levels of bank profitability. The current large spread between cost of funds and interest earnings means that no efforts to calibrate competing rates of return for varying deployments of funds need be undertaken. None of the banks we surveyed was able to provide us with a blended, or average, cost of funds. Undoubtedly the information is available, as it is a simple matter (and standard feature of banking software) to obtain cost of funds calculations.

As the economy grows in a deregulated environment, and outside banking institutions become active in Iraq, it may be assumed that competitive pressures will shrink the spreads commercial banks currently enjoy.

The writer knows from teaching a good number of Iraqi bankers credit analysis, that such standard profitability measurements as Return on Assets and Return on Equity are not widely known. On a positive note, there is considerable interest among both senior and middle managers in training courses focused on analytical skills - Managerial accounting, credit analysis, bank analysis, profitability measurement, and the like.

The Credit Culture

As noted in the 2003 study, Iraqi banks, historically, have lent on the basis of collateral. The only analytical effort expended in the process involved appraising the collateral on offer and registering it in the name of the bank. To describe it as "asset-based lending," missed the point: Banks in Iraq did not customarily finance the acquisition of equipment and machinery. All lending, until very recently, was secured by pledged commercial or residential real estate, sometimes for as much as 300% of the value of the loan received. As a result of Izdihar training efforts and the advent of the ICBG, we believe that a shift in the lending culture is now under way.

Only in 2005, with real estate values plunging and banks facing a security situation which made perfecting liens on real property difficult and even dangerous, have banks turned to other forms of security. Among them are pledged shares (in face amounts well over the value of funds received), gold, and personal guarantees.

Banks in our survey reported anywhere between 25% and 300% collateral coverage (half of the respondents require collateral ranging between 100% and 300% of the amount lent). As banks question the efficacy of securing credits with pledged real estate, there appears to be some growth in loans collateralized less than 100%. While Middle East Bank reported that 95% and Mosul Bank 96% of their collateral coverage

was in the form of pledged real estate, Ashour and Investment rely more on gold and pledged securities (which can be held in their vaults).

Loans to Deposits

A standard measure of bank efficiency is the usage of deposit funds to generate profits by deployment as earning assets. We are primarily interested in seeing what percentage of deposits are deployed as loans, of course. This ratio also gives the analyst an idea of a bank's liquidity, although there are better methods of measuring liquidity which will be discussed below. The higher the ratio, the more efficient a bank is deemed to be; yet, the higher the ratio, the less liquid is the bank.

Given the high level of liquidity throughout the system, the ratio is primarily of interest to us as a measurement of efficiency. Western banks generally show quite high Loans to Deposits ratios – 65% - 70% is normal. In the West, central banks are ready to inject liquidity into the banking system whenever required: In the United States, for example, the Federal Reserve Bank and commercial banks in the interbank market, are available to provide overnight funds to banks facing unforeseen liquidity squeezes (as long as there is no underlying major cause for concern).

The Iraqi market is highly liquid, and the CBI responsive to banks' needs.

Iraqi banks exhibit very low Loans/Deposit ratios: The overall average for the twenty-one banks is 56%; however, after removing the four banks with ratios in excess of 100%, the average drops to 28.52%. As a major goal of Izdihar is to help broker an SME lending industry in Iraq, we believe it advisable for CBI to adopt a policy of encouraging banks to raise their Loans/Deposits ratios.⁷

Capital Adequacy

All banks in the survey have greatly increased their capital over the past three years. Only Economy and Barakah have failed to raise their capital to the ID 10 billion (\$5 million) level mandated under the CPA.

With the exception of the troubled Barakah Bank and Economy Bank, leverage and capital adequacy ratios for the private banks are acceptable.

⁷ The author recalls a similar situation in Palestine in the late 1990s which found local banks placing most of their funds on deposit abroad in Amman or Jerusalem. The Palestinian Monetary Authority established and vigorously enforced a regulation calling for the achievement within a specified time frame of a 50% Loans to Deposits ratio. Similar regulatory efforts are used by US banking authorities to penalize banks for "red-lining" certain districts or neighborhoods.

The Basel convention requires that Tier 1 capital represent 8% of risk-adjusted assets, and CBI has established a 12% ratio as the Iraqi guideline. Given the high liquidity of all Iraqi private banks, and the relatively low level of earning assets as a percentage of total assets, risk-weighting of assets (cash and its equivalents is 0 and most of what is shown on the balance sheet in capital and reserves is Tier 1 capital) will produce a margin comfortably in excess of the 8% Basel standard. The exceptions, if there are any, would only be in cases of high contingent liabilities (letters of guarantee, for the most part).

Banks which have not attracted a foreign partner will continue to lag behind their brethren with foreign shareholders in capital, growth potential and international reach. Their capacity to conduct international trade may remain compromised by an inability to attract lines of credit for the confirmation of letters of credit from international banks, while their counterparts will be able to rely upon their foreign partners to either guarantee their L/Cs or issue them on their behalves. Given the precarious state of the Iraqi economy as well as political uncertainty, local banks without foreign partners, in all likelihood, will remain unable to open correspondent banking accounts in such financial centers as London and New York.

Liquidity

Liquidity may be measured by the ratios Liquid Assets/Total Assets, and Liquid Assets/Deposits.

The first ratio provides an absolute measurement of liquidity - cash and bank deposits as a percentage of total assets. Under ideal circumstances, it is inadvisable for banks to maintain a high liquidity ratio: Generally amounts left on deposit earn much less than earning assets – loans and investments. Thus, for efficiency and profitability reasons, banks in Western countries closely monitor their cash positions, keeping them as low as possible. Careful asset-liability management allows them to keep liquidity low, and borrow overnight or for short periods on the interbank market or from the central banking authority to cover unanticipated cash demands.

The second ratio shows coverage of the deposit base by cash and near-cash assets. As such, the numerator includes short-term investments as well as cash and bank accounts. Generally speaking there is no need to have a one-to-one relation between liquid assets and deposits: Extremely low ratios are commonplace in the West. Barring a run on the bank, depositors do not appear *en masse* demanding to withdraw their funds, and banks learn to adjust their liquidity position to fit the normal requirements of day-to-day business.

Extremely high liquidity has characterized the banking system from late 2003 until the present. Banks were, and remain, beneficiaries of the public's concern about leaving money "under the mattress" during times of civil insurrection and general

lawlessness. For the sake of comparison, the ratios of HSBC and JPMorganChase for 2005 were as follows:

	<i>Cash and Due/ Total Assets</i>	<i>Liquid Assets/ Deposits</i>
Average of 21 Iraqi private banks	57.53%	367.71%
HSBC	1.27%	3.54%
JPMorganChase	4.86%	38.41% ⁸

On average over half of a bank's assets were in cash or bank deposits, while coverage of deposit liabilities is by an average factor of 367.71%, or nearly four times.

There are several explanations for this anomaly:

1. A high degree of risk aversion on the part of the banks surveyed;
2. The difficult political and economic environment in which the banks operate;
3. An alternative deployment of funds that is much less risky than lending, and that offers a good return.

Of the three, the deciding factor is probably the last. The CBI pays banks 12% on 30-day deposits⁹, just two or at maximum four percentage points below rates charged on loans, and before reserves (of at least two percent). Regardless of the fact that most banks debit interest from the net proceeds of the loan (raising the yield to above the nominal rate), the offer of 12% risk-free is probably the critical factor (and the factor that more than one Managing Director has mentioned to the author as the primary disincentive to lending).

We have approached the CBI to reconsider the rates paid on deposits (far higher than rates obtainable abroad, for example). It is difficult to imagine the banks' foregoing such easy money for the less predictable returns from SME lending, whether guaranteed or not – despite the fact that both rates on loans (something in the neighborhood of 25% currently, and deposit returns of 20%) are below the inflation rate.

Branch Systems

⁸ The difference between the two with respect to the Liquid Assets/Deposits ratio is probably explainable in JPMorganChase's extensive security trading operations, and the need to maintain a large portfolio.

⁹ Raised to 18% in late November, and currently 20%.

By 2006, the banks' branch networks have been restored to their pre-war status, and some banks have added branches (particularly in the North, where the security situation is better and economic investment is taking place).

Telephone communications have been restored to the branches, facilitating interbranch payments. The charge for payments is .00125 of the amount transferred plus a \$4.00 fee.

With the exception of branches of the state-owned banks, Rafidain and Rashid, (as well as the Agriculture, Social, Real Estate and Industrial Banks) much of Iraq is not served by commercial banks. There are no private commercial bank branches in many large towns (the equivalent of county seats) throughout the country.¹⁰

¹⁰ County seats (*marakaz al-aqadhiah*) with no private bank presence include Hamdaniyah, al-Rutbah, al-Majr al-Kabir, Shahr bazar, Binjoun, Khaneqin, Hawijah, Shaqlawah, Jouman, 'Ali al-Gharbi, ar-Rafaie, 'Emadiyah, Sarsank, Shatrah, Zirkawah, Badra, Medaiin, Kasaibah, Jubaish, and al-Hayi'.

Table 2: Private Bank Branches 2006

<i>Name of Bank</i>	<i>Baghdad</i>	<i>West</i>	<i>East</i>	<i>North</i>	<i>Central</i>	<i>South</i>
Warka ⁷	15	Al-Qaim		Mosul (4) Kirkuk Sulaimaniah	Najaf	Nasiriah Basrah
Investment	14 Mahmudiah				Hillah, Kut Najaf, Kerbala	
Basrah*	2				Najaf	Basrah (4)
Sumer	6					
Middle East	7	Samara		Mosul (2) Kirkuk		Basrah
Islamic	4	Ramadi Falujah		Mosul	Najaf	Basrah
Commercial	10				Hillah	Basrah
Emerald				Arbil, Dahuk		
National	3			Mosul		
Baghdad	10 Mahmudiah	Falujah	Baquba	Mosul- Ninevah Kirkuk Sulaimaniah	Hillah Karbala Najaf	Basrah
Credit	10				Hillah	Basrah
Commercial	9					Basrah
Gulf	4				Hillah Najaf (2) Karbala	Basrah
Mosul	3			Mosul (2) Tikrit Sulaimaniah		
United	4					
North	2			Sulaimaniah		
Ashour	1					
Dar as-Salaam	8 Amiriyah			Mosul	Karbala Diwaniyah	

* Branch in Damascus

Management

All members of senior management of the private banks with one exception are ‘graduates’ of the Rafidain Bank, and have no experience working for foreign banking institutions. Antiquated Rafidain systems and isolation from the rest of the banking world, account in large part for the banking sector’s relative backwardness.

While Rafidain was once in line with banks in Europe and the US, over the past three decades (prior to the 2003 war) it devolved into a sort of state funding apparatus, reminiscent of the banks operating in the former Soviet Union. Its *raison d’etre* migrated from finance to funding: It became a conduit for government monies for state enterprises, issued letters of credit on behalf of the state and the public sector, and performed certain statistical and administrative functions for the government and the Ministry of Finance and Central Bank.

The credit function as performed by Rafidain involved at most an appraisal of the collateral on offer and its registration in the name of the bank.

Thus, while most of the private bank managing directors have had long, distinguished careers at Rafidain, Rashid and the Central Bank, and have an excellent grasp of who’s who in Iraq and how things get done, they are not trained bankers in contemporary terms. Likewise, bank staff have had no formal banking training beyond limited operational courses in data entry and the like.

There is an ongoing need for banking training of all kinds, and an associated need for Iraqi bankers to travel abroad and see how the rest of the world - both the Arab world and Europe and the US - are operating in the 21st century.

Izdihar and ICBG Training Programs

Over the life of the Izdihar project, more than 500 bankers have been trained in 30 plus banking courses developed especially for Iraqi private banks. A core curriculum including the Managerial Accounting and Credit Analysis course (around 100 bankers have either completed this course), Loan Administration, Security and Collateral, and Loan Classification and Reserves has been offered Credit Officers from over twenty private banks.

The project can take credit for promoting the Credit Officer concept – the creation of loan officers responsible for developing and servicing their own loan portfolios - to replace the existing division of responsibilities among multiple bank departments. Centralizing responsibility for marketing, loan structure, credit recommendation, and repayment in the hands of individual Credit Officers, helps build *esprit de corps* while at the same time fostering a healthy level of competition. It also highlights the importance of the loan portfolio’s profitability.

Courses in Goal Setting and Marketing, Performance Planning, and setting up a model SME lending unit, round out the offerings for Credit Officers and Credit Department managers. In addition, the SME Development/Bank Lending Component has offered more general courses in Basle requirements, Money and Banking, Anti-Money Laundering, Corporate Governance: Specifically-targeted courses such as Internal Audit and Control have fleshed out the curriculum.

Recognizing the importance of earning the support of senior bank managers in the bank capacity-building effort, the component has offered courses specially tailored for senior management covering credit appraisal, cash flow lending, bank profitability, and the role of boards of directors.

Finally, under the auspices of the Iraq Company for Bank Guarantees (ICBG) training efforts have centered on the program's Participating Bank Agreement, Loan Agreement, and using the forms and following the procedures required for participating banks to qualify for ICBG guarantees.

Summary of Findings

Internal organization of the banks and the assignment of responsibilities do not correspond with Western standards. There are no internal auditors, no internal control departments (instead there is an "inspection" department that carries out branch audits). No bank has a credit manual or an operating manual. Central Bank circulars are kept in a folder and not replaced when updates are issued. Auditing is limited to proving cash totals in the branches, and justifying various operating statements. No oversight is exercised with respect to the loan portfolio: There is no risk management function anywhere in the banks, no portfolio review function, and – until the recent promulgation of credit standards by the CBI – no standards set or reviewed for the contents of a credit file (beyond the setting of basic documentation requirements – which did not include financial statements of borrowers).

While the banks have made strides over the past three years in the improvement of internal operating (and reporting) systems – computer hardware and software – there is still only one bank to our knowledge capable of publishing monthly balance sheets and income statements. No credit department head receives a daily credit outstanding and past dues report. It takes the banks between six and nine months to complete their annual reports (as of November, 2006, two still had not completed them for 2005) and, with the exception of one bank, no interim figures are published .

As mentioned above, we requested the private banks to provide us with deposit breakdowns and a cost of funds calculation. Not one of the respondent banks was able to do so.

The payment system operates via telephone and can handle payments within one bank's branch system. The Baghdad check clearing house is operating once again, but

checks take six days to clear as opposed to three days before the war. There are clearing houses in the governorates as well: The Central Bank has branches in Basrah and Ninevah and handles check clearings for these governorates and those surrounding them that do not have clearing houses. Rashid Bank in Kirkuk and Rafidain Bank in Babylon perform the same function for banks within these areas, in lieu of the Central Bank. The CBI branch in Arbil has become more of a central bank for Kurdistan than a branch of the CBI.

There is no inter-governorate clearing system, per se. For an additional fee, the clearing house banks themselves will contact the issuing bank and make payments to check-holders after having obtained appropriate authorization.

As mentioned above, there is not a system in effect for assigning borrowing relationships to individual credit officers. Instead, responsibility for handling lending relationships is shared among several departments. And when responsibility is shared, it is generally shirked. However, since Izdihar began its training efforts, Middle East Bank and Mosul Bank have adopted the Loan Officer concept, giving officers their own portfolios and making them responsible for everything from marketing and application preparation, to follow-up and final repayment.

All credit authority is centralized (at a head office credit committee) and an extremely large percentage of loans must be approved by the Board of Directors, none of whom have any banking and credit experience or background.

Banks are wasting their efforts – in the writer’s opinion – introducing novelties such as credit cards – but without the “credit” feature, and ATMs. The cards must be secured by blocked deposit accounts, and ATMs in a country like Iraq are an idea whose time not only hasn’t come, but seems very, very far away indeed.

Credit products are limited in scope – overdrafts and short-term loans. The banks’ preferred customers – traders and wholesalers – some of the most difficult credits to analyze (because the nature of their businesses keeps changing with the different mix of goods they import and sell) and the most difficult to monitor. The preference for overdrafts – while certainly convenient for the traders – leaves the banks in the position of not knowing whether their loans are performing or not. Debiting interest periodically to an already overdrawn account and treating it as income is as close to the devil’s playground as banking can become.

Some banks offer short-term loans to persons who use the proceeds to speculate on the local stock market – and without a margin requirement (but subject to varying collateral conditions).

The most critical shortcoming, in the writer’s opinion, is the failure of the banks to perform their principal function as financial intermediaries - to attract deposits and lend funds to credit-worthy enterprises throughout the country. It is this vital role that the

Izdihar project has attempted to address, through extensive training efforts and by means of guarantees offered through the Iraq Company for Bank Guarantees.

Conclusion

While there has been development in the private banking sector over the past three years, the hope that change would be brokered by sectoral foreign investment and the associated enforced competition has largely gone unrealized. The reasons for this are:

1. The poor security situation in Baghdad;
2. Severe dislocations in the non-state-sector national economy;
3. The virtual cessation of foreign investment beyond Kurdistan.

One is of the impression that potential foreign investors in the banking sector are still sitting on their hands, watching and waiting to see what the future will bring. Of the seven banks and companies that have formed joint ventures with Iraqi banks, none has reoriented or redirected the bank acquired to a position of active lending. Indeed, only one foreign investor has sent a staff member to Iraq to take over the affiliated institution (HSBC). It seems that the foreign partners have made strategic investments (on relatively nominal terms given the potential of a renascent Iraqi economy operating under conditions of political stability) and are willing to sit on the sidelines until there is some sign of improvement by which they might justify becoming more involved. The exception to this picture is Kurdistan, where three Lebanese banks are in the process of opening branches or establishing affiliates.

Should initial encouraging results of the current troop buildup continue and overall security conditions improve, and should foreign investors take a more active role in the management of the institutions they have acquired, one might expect the effects on the banking sector to be considerable: No longer would the time-honored practices of the Rafidain Bank be acceptable: The inefficiencies and credit oversights, the lack of banking products, the lack of branch systems, the absence of a profitability-driven, yet consumer- and business-oriented banking culture, would no longer be tolerated. Competition would force the smaller banks to merge, and the larger ones to adapt – and quickly. Several banks are already demonstrating that – with the support of the ICBG – they can make good loans to deserving businesses on a cash-flow (rather than a collateral) basis. As guarantee company outstandings increase, and as the loans themselves repay, it may be assumed that momentum will grow for increased cash-flow-based lending.

One would hope that the Central Bank might use its considerable power and influence to support the development of an SME lending industry by encouraging banks to lend, by insisting that they increase their Loans/Deposits ratios, and by limiting the amount of funds on which they will pay high deposit rates. Maintaining high interest rates, of course, is one of the IMF's favorite weapons in the anti-inflation arsenal. Imposition of high interest rates, however, has the effect of protecting foreign investors and creditors at the expense of local businesses, in particular small businesses. And, as

the IMF itself admits that interest rate adjustments in Iraq have practically no economic effect as the banking system is, by its own description, “inert,” the benefits of encouraging banks to lend to SMEs would seem to outweigh potential inflationary effects (which, in any event are much more closely tied to the increase in oil prices and the effects of the ongoing insurgency than to any other factor).¹¹

Recommendations for the CBI

1. Lower deposit rates paid to more closely reflect comparable LIBOR and Fed Funds rates and encourage lending OR limit the amount of funds which individual banks may place at the Central Bank;
2. Further encourage banks to engage in lending activities by pressuring them to raise their Loans/Deposits ratio;
3. Require additional disclosure on the part of banks with regard to exposure to guarantors and groups;
4. Promulgate regulations governing overdraft lending, in particular clean-up periods, annual review, classification and reserves;
5. Change the format of bank balance sheets to clearly reflect Gross Loans and Advances, Loan Loss Provision, Net Loans and Advances;
6. Require that transfers to various reserves, including the Loan Loss Provision, be clearly indicated on Income Statements;
7. Insist that all credit facilities be reviewed on an annual basis rather than the biennial basis required at present.

¹¹ See IMF Country Report 06/301, August, 2006.