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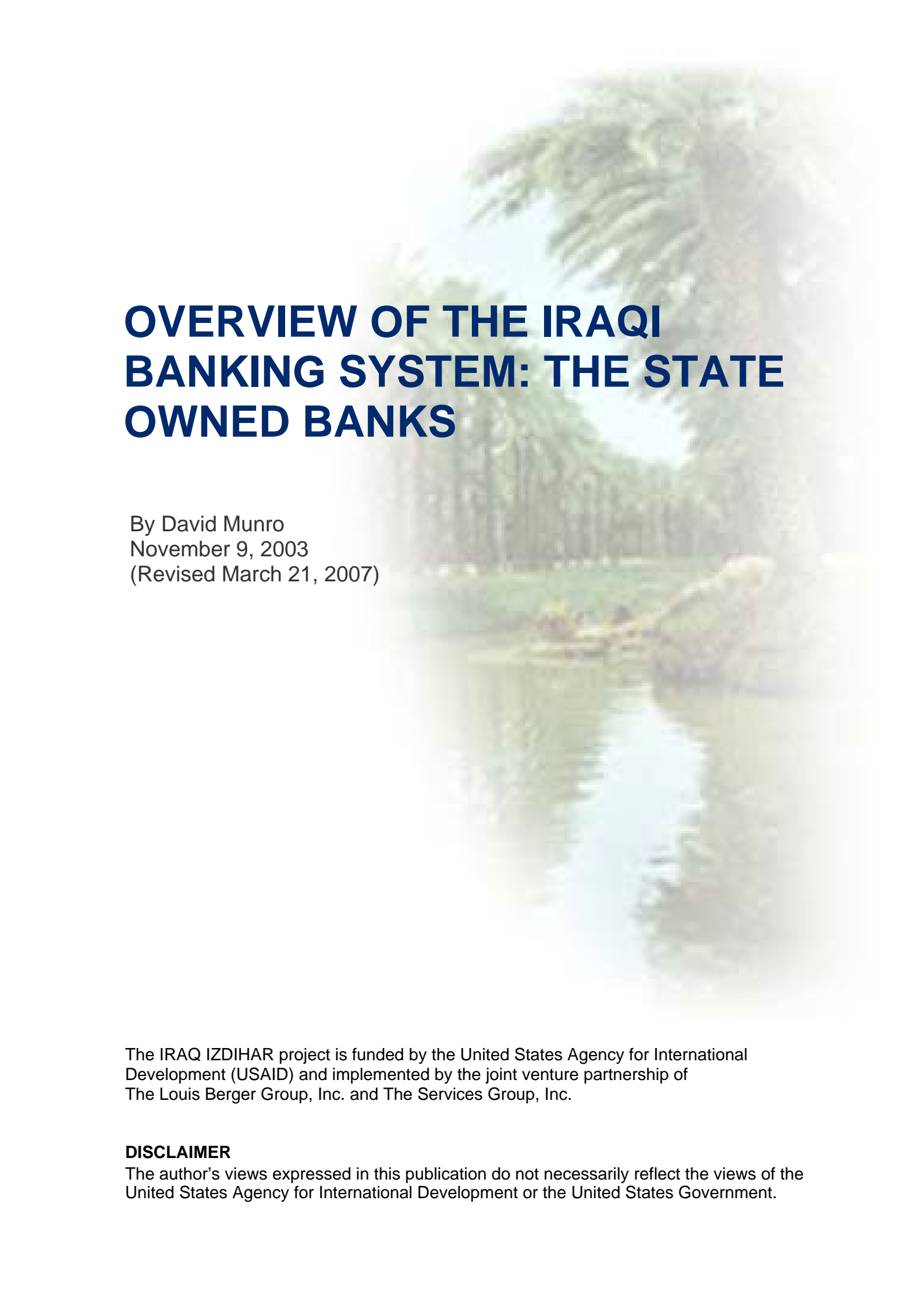
IRAQ PRIVATE SECTOR GROWTH AND EMPLOYMENT GENERATION

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OVERVIEW OF THE IRAQI BANKING SYSTEM: THE STATE- OWNED BANKS



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By David Munro
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Background: The Iraqi Banking System

There are six public-sector banks and 23 private sector banks in Iraq operating as of November, 2006. Public sector banks include the two large commercial banks, Rafidain and Rashid, and four special-purpose banks: The Real Estate Bank; the Agriculture Bank; the Iraq Bank (formerly the Socialist Bank) and the Industrial Bank.

Rafidain Bank was founded in 1941 and was originally a privately-owned bank, established by a member of the prominent Chalabi family. By the early 1960s the following banks were represented in Baghdad: Ottoman Bank; the Eastern Bank (British-owned); the British Bank of the Middle East; Federal Bank of Lebanon; National Bank of Pakistan; Arab Bank, Ltd.; Intra Bank (Lebanon); and the Iraqi banks, Rafidain, Commercial Bank, Credit Bank and Bank of Baghdad. In 1964, during a wave of nationalizations under the first Ba'ath regime, banks were seized and merged into four groups – Rafidain, Commercial, Bank of Baghdad and Credit Bank.

In 1970 a further consolidation took place, with banks merged into either Rafidain or Commercial, and in 1974, the Commercial group was put under the Rafidain banner, leaving the country with one state-owned bank. On January 1, 1989, the Rashid Bank was spun off from Rafidain (and encumbered with most of the latter's non-performing assets).

Following the Gulf War of 1991, the government once again sanctioned the establishment of private banks. Prominent industrialists and trading families took advantage of this relative liberalization of the financial sector, and established banks whose *raison d'être* was financing endeavors associated with the founders' core lines of business. While direct lending to Board of Directors members is controlled by the Central Bank (prior approval must be granted), associated companies and firms may be assumed to account for a substantial proportion of the banks' portfolios.

Nevertheless, there are banks that are actively engaged in supporting small enterprises – primarily traders. Examples are the Economy Bank, whose head office is located in a market or *suq* just north of the Bab al-Sharjah Square, and the Basrah Private Bank, whose head office abuts Sadr City (formerly Saddam City), and which has a branch in the Sheikh Omar area of the city, a district dotted with small workshops which make up this branch's customer base. Even the relatively large Bank of Baghdad claims to extend many small credits in the several hundred dollars range, and to have a very diversified portfolio.

Indeed, the impetus for establishment of these banks – aside from serving as funding arms for family enterprises of prominent shareholders – was an attempt to reach some of the vast majority of small businesses in Iraq not associated with the regime. The

state-owned banks alone were allowed to lend to state-owned enterprises, and such lending explains the preponderance of government risk on their books. The private banks were in general well capitalized at the time: the prevailing exchange rate pre-war (officially imposed) was \$3.20 to the Iraqi dinar. With the current exchange rates at about ID2,000 = 1US\$, a bank with capital of ID 500,000,000 – once worth \$1,600,000,000 – finds itself with a net worth of only \$250,000.¹ Accordingly, the Coalition Provisional Authority (CPA) Ministry of Economic Development charged the private banks with raising their capital to the equivalent of \$5,000,000 within 18 months – ID 10,000,000,000 at the prevailing exchange rate. By financial statement date 2005, almost all of the private banks had met the new capital requirement.

The effects of the Iraq War on the banks were devastating, for state and private banks alike. The state banks suffered the most: Rafidain Bank lost an estimated \$300,000,000 to looters and its head office and many branches were completely looted and burned. Currency losses at Rashid Bank totaled ID 138 billion, equivalent to \$69,000,000. A large number of the private banks transferred their banknotes to the Central Bank's vaults before the war, thus avoiding the heavy losses that characterized the two large state-owned commercial banks.

In addition to stolen banknotes and looted premises, of course, was the damage sustained by customers of the banking system, and, by extension, the banks' loan portfolios. It may be safely assumed that a large proportion of loans on the books of the entire system is non-performing; banks are making efforts to help customers recover by restructuring and rescheduling amounts past due. As there was not a classification and reserve policy in effect in Iraq (a Basel-compliant policy was promulgated by the Central Bank in July, 2006), it was difficult to quantify the amount of arrears or accurately assess the degree of lending portfolio weakness in post-war Iraq. (For more on this topic, see "Regulatory Environment," below.)

Fortunately for the private banks, they were prohibited from lending to public sector companies: This lending was the exclusive domain of the state-owned banks, and the damage sustained by these industries in post-war looting coupled with the questionable economic viability of many of the firms, meant that public sector debt on the books of Rafidain and Rashid was virtually all non-performing. Indeed, the CPA stripped from these two banks' books all assets and liabilities associated with public sector companies.

Paradoxically, while the banking system as a whole was essentially insolvent (non-performing assets mean that the banks probably could not meet normal depositor withdrawal demands) in the immediate post-war period, system liquidity was high. Insecurity associated with the war and its aftermath occasioned a tremendous growth in bank deposits. The system remains awash in liquidity from new deposit accounts, a substantial amount of which is left on deposit with the Central Bank of Iraq.

¹ Exchange rate prevailing in 2004. The current rate is 1 USD = ID 1,277

Communications within the country devastated by the war have now been restored and payment systems (within banks) cobbled together using mobile phone technology.

Modernization of IT systems has been carried out in many of the Iraqi banks.

Banking Products and Services

Services offered by Iraqi commercial banks include current accounts, savings accounts and time deposits, short-term overdraft and bills discounted facilities, as well as short-term loans and advances. Banks also offer bid, advance payment, and performance bonds (but the maximum tenor is 12 months). A few banks offer loans over one year in tenor.

Even banks engaged in medium-term financing do so on a “roll-over” basis; there is no medium-term funding available in the market, thus rates must be reset on an annual basis.

The Central Bank does not encourage consumer finance (bankers told the writer that it was prohibited) and real estate lending is confined to the Real Estate Bank. (The environment, however, is changing).

Regulatory Environment

The Central Bank of Iraq performs the following regulatory functions:

1. Issues banking licenses;
2. Promulgates rules and regulations under the banking law for regulation of banks;
3. Carries out an inspection regime;
4. Influences monetary policy;
5. Serves as lender of last resort

In addition to its regulatory role, the bank has a training department which offered in pre-war times a range of lectures and workshops for commercial bankers, and published studies carried out by the Inspection Department on topics of concern to local bankers.

The Central Bank maintains a register of all borrowers which may be accessed by commercial banks to check customer or applicant liabilities to other members of the banking community.

Monetary Policy

Formerly, the Central Bank of Iraq controlled monetary policy by:

1. Controlling the amount of currency in circulation;

2. Establishing reserve requirements on bank deposits;
3. Setting the rates payable on bank deposits;
4. Setting rates charged on loans;
5. Setting foreign exchange rates.

As a result of reforms introduced by the CPA, foreign exchange rates are set by the market, and the Central Bank has undertaken currency auctions (sales of US dollars) to manage the \$-ID exchange rate.

The other control mechanisms are still in place. Reserve requirements on bank deposits are as follows:

Savings Accounts	5%
Time Deposits	10%
Current and Other Accounts	20%

Minimum rates banks must pay on deposits are:

Savings Accounts	7%
Six month time deposits	8%
One year time deposits	9%
Two year time deposits	10%

Maximum lending rates banks may charge were formerly regulated, as follows:

Short-term loans and advances	14%
Medium-term (to five years)	15%
Long-term (over five years)	16%

Banks are now free to set their own lending rates, and a number of banks have raised interest rates charged on loans to 20-25%. No change to deposit rates appears to have taken place over the past three years, however. A new regulatory framework is expected to evolve over time. The central banking and banking laws have been reframed and promulgated, and specific regulations not covered in the laws themselves are currently under review. In particular, a loan classification and reserve policy was circulated in July, 2006. It calls for the following:

<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%

Capital Requirements

Iraqi banks are required by the new banking law to have paid-in-capital of not less than \$5 million in Iraqi dinars by the end of 2004. New banks established by foreigners must have a minimum capital of \$25 million. For branches of foreign banks, the law requires that they maintain at all times an (unspecified) excess of assets over liabilities. In addition, banks in Iraq are required to maintain a Tier 1 Capital/Risk Adjusted Assets ratio of not less than 12%. As mentioned above, by December 31, 2005, all but two banks had met the capital requirement.

Regulations and the Inspection Regime

Prudential ratio requirements for banks included the following under the former banking laws:

1. Net Fixed Assets plus Shares/Capital Funds	Not over 150%
2. Loans/Deposits	Not over 70%
3. Deposits/Capital Funds	Not over 16x
4. Tier 1 Capital/Risk Adjusted Assets	Minimum 12% (new regulation)

The new commercial banking law (2004) did not include prudential regulations, however, so these former ratio requirements are essentially in abeyance.

In addition, without explicit Central Bank approval, no amount in excess of 5% of capital may be lent to a single borrower (or related party). All board of directors lending must be submitted to the Central Bank for approval.

New related-party guidelines were promulgated by the CBI in 2006.

The Inspection Department, with a staff of 90, carries out annual inspections of all banks in addition to “surprise” inspections.

Under the former regime, only the Central Bank could open letters of credit. The Trade Development Bank was established specifically to open letters of credit, under arrangements with consortium banks.² Other banks are authorized to open L/Cs, but the lack of lines of credit precludes them from doing so. Nevertheless, some private banks are able to have affiliated institutions open credits on their behalf.

Central Bank regulations identified by private bankers in 2004 as obstacles to lending included the following:

- Central Bank rules require borrowers to be registered as members of various trade and industry associations;
- Consumer loans are prohibited by the Central Bank;
- Mortgage loans may only be made by the Real Estate Bank;
- The company or the commercial law stipulates that firms may not borrow in excess of 300% of their capital. As many SMEs are thinly capitalized, this is a constraint;
- Loans from state-owned banks are senior debt under Iraqi law, while loans from private banks are not. The law provides for a maximum four-month incarceration for non-payment of amounts due a private bank, while the penalties for defaulting on loans from state-owned banks are much stiffer;
- Amounts credited to loan loss reserves are taxed. A related problem is the lack of provisioning for bad debts throughout the banking system. By Central Bank regulation banks may NOT establish more than a 5% reserve;
- Only members of a union, guild, or trade association may co-sign loans.

The writer is unsure as to whether or not these issues are still unresolved. And, as mentioned above, banking regulations not specifically covered in the banking law are currently being reviewed. All previous regulations are believed to be still in force, however, creating some conflicts with the new law.

The Credit “Culture”

The credit culture in Iraq is largely driven by loan collateral. Only a small number of the private banks report making credit available on an unsecured basis. The overwhelming majority of loans is secured by real estate, and there is quite an involved system for registering and pledging real estate to banks in order to obtain financing.

² TBI consortium banks open L/Cs on behalf of the TBI, for the account of government of Iraq ministries. Banks in the consortium are JPMorganChase, Standard Chartered Bank, Australia and New Zealand Bank, Bank Millennium SA, National Bank of Kuwait, Internationale Nederlanden Group, Bank of Tokyo-Mitsubishi, Calyon, HypoVereinsbank AG, and SanPaolo IMI S.p.A.

Property is registered by the land registry office of the Ministry of Justice. There are eight property registry locations in Baghdad, and banks typically send three-man teams out to appraise property, one person each from the bank, the registry and the tax office.

The attention devoted to real estate appraisal is not matched by the credit analysis process. Indeed, there appears to be, in essence, no credit analysis process. Basic borrower information may or may not be collected: A long list of documentary requirements added to the real estate appraisal constitute the bulk of the credit file. (See Appendix C, Rashid Bank documentary requirements, for an example).

A number of banks report accepting third party guarantees - in most cases but not all - in addition to real estate collateral.

Cash flow analysis seems entirely unknown to the Iraqi banking community. Some banks advised us that one of their “documentary requirements” is a feasibility study or financial statements “if available,” but no figures – other than the amount of the loan requested - were presented for any credit discussed while this consultant sat with the Rafidain and Rashid credit committees.

Banks distinguish between ‘facilities’ – overdrafts, bills discounted and letters of guarantee, and ‘loans’ – credits extended for specific purposes. Overdrafts and discounted bills make up the lion’s share of all bank portfolios (excluding the state-owned banks – see below). Overdrafts are tied to ceilings, and the facilities are backed by collateral in almost all instances. However, review of “short-term” facilities is often every two years (Rafidain formerly reviewed these facilities only every four years!). Most loan agreements call for the borrower to repay interest apart from the overdrawn balance, but there are many instances in which interest is simply debited to the overdrawn account. As is the case generally with overdraft financing, it is difficult to ascertain whether or not an overdraft account is ‘performing,’ as there is not a specific repayment schedule. Loans, on the other hand, generally have ‘bullet’ (single payment) repayments at the loan’s maturity.

This consultant attended credit committee meetings in both Rafidain and Rashid Banks in late 2003, and was impressed by the need of all concerned to receive credit training. As virtually all of the senior and middle management of the private banks spent years with Rafidain Bank, the country’s bankers have a shared credit culture, and procedures are very similar in all of the banks. There are, however, differences in portfolio concentration, with various of the smaller banks reflecting the industry make-up of the districts served by their branches. Sumer Bank, for example, numbers many automobile repair shops among its clientele, Basrah Bank has small aluminum fabricators, and Economy Bank many small traders-retailers (*suq* or bazaar merchants). Basrah Bank is the only bank encountered which includes vehicle finance in its product line: The bank finances transport vehicles, and registers them in its name with the Department of Traffic.

The State-Owned Banks

There are six state-owned banks: Rafidain Bank, Rashid Bank, the Agriculture Bank, the Industrial Bank, the Estate Bank, and the Iraq Bank (formerly the Socialist Bank). All are functioning once again to a greater or lesser extent.

The specialized banks were heavily involved in state-owned enterprises, and in regime-related lending activities. Only Rafidain and Rashid made commercial loans to a wide range of enterprises.

Rafidain and Rashid, the two state-owned commercial banks, possess large, nation-wide branch systems (153 and 170 branches respectively) and are in many locations the only banks available to Iraqis. By comparison, the private banks total 175 branches among them.

Rafidain and Rashid Banks dominate the Iraqi banking sector, accounting for over 80% of the banking system's assets: When the four specialized banks are added, the figure rises to more than 90%. Rafidain's total assets as of late 2003 were estimated to be \$1.03 billion, while Rashid's assets totaled \$750 million.³

The Agricultural Bank was founded in 1936 and traditionally has lent to private sector agriculturalists. The bank has 40 branches. Total assets in 2003 amounted to \$52.8 million.

The Industrial Bank was split off from the Agricultural Bank in 1940. Clients are both public- and private-sector companies. The bank has nine branches. Assets as of late 2003 totaled \$34.7 million.

The Real Estate Bank was established in 1949 to provide housing construction finance and finance for the tourist industry. The bank has 25 branches, and total assets of \$10 million.

The Iraq Bank (Socialist Bank) was founded in 1991, and is the smallest of the state-owned banks with four branches. Total assets were \$8.4 million as of 2003.

³ Total asset figures as quoted in "Working Paper, Iraq – United Nations/World Bank Joint Needs Assessment," October, 2003.