

THE LEGAL AND REGULATORY FRAMEWORK FOR MICROFINANCE IN IRAQ

JULY 2015



Currency Equivalents

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Acronyms

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
CBI	Central Bank of Iraq
GDP	Gross Domestic Product
ILO	International Labor Organization
NBFI	Non-Bank Financial Institution
NGO	Non-Governmental Organization
MENA	Middle East and North Africa
MoLSA	Ministry of Labor and Social Affairs
MFI	Microfinance Institution
MSME	Micro Small and Medium Enterprise
SME	Small and Medium Enterprise
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

Financial inclusion – defined here as the share of individuals with access to quality formal financial services including credit, savings, and insurance services – is increasingly recognized as an important contributor to global development. From a macro-economic perspective, access to finance has been proven to be positively correlated to economic growth and to reduced inequalities. For low-income individuals and households, it is critical for improving household welfare by promoting productive investment and helping manage economic shocks.

Similar to other countries in the Middle East and North Africa (MENA) region and beyond, the demand for financial services is largely present in Iraq. Recent data reveals a significant gap between Iraqi citizens who saved or borrowed *formally* and those who did so *informally*. Similarly, while Micro, Small, and Medium-Sized Enterprises (MSMEs) constitute the majority of enterprises in Iraq, only a small fraction reports having received a loan from a conventional bank.

Over the past few years, Microfinance Institutions (MFIs) in Iraq have emerged as credible sources of financing for low-income households and entrepreneurs, both underserved by conventional banks. Microfinance services in Iraq, however, are still nascent and far from meeting their full potential. Similar to many countries in the MENA region, MFIs in Iraq were set up as non-governmental organizations (NGOs) supported by a steady influx of donor funding. While these NGOs were initially able to grow through donor support, they are now struggling as donor resources have dwindled, preventing them from making the necessary investments in capital and infrastructure to meet growing client demand.

Many countries address this funding challenge by allowing institutions to provide financial services as companies or banks, helping them raise capital, provide new services, and increase their outreach in a sustainable manner. A similar path could be envisioned in Iraq, but is currently obstructed by regulatory hurdles. This diagnostic report aims to present and assess the current microfinance landscape in Iraq, including the legal and regulatory framework, recommend policy improvements to enhance the sustainability and operating environment for MFIs and their clients. This report argues that the current legal and regulatory environment for microfinance in Iraq hinders the growth and sustainability of the sector and furthermore advocates several short and medium term policy recommendations to enhance the overall operating environment for MFIs, the sustainability of the sector, and impact for clients.

Overview of the Legal and Regulatory Framework Governing Microfinance in Iraq

The microfinance sector falls under the regulatory jurisdiction of multiple laws and supervisors, each spanning varying degrees of control over the sector. NGO MFIs are registered with the NGO Directorate under the NGO Law of 2010, which defines them as entities that engage in non-profit activities. A separate NGO Law was approved by the Iraqi Kurdistan Region's Parliament in 2011. There are also a number of laws aimed at supporting small businesses in Iraq that impact microfinance development. In 2012, the Parliament passed the 'Support of Small Income-Generating Project Law', which provided a vehicle for the government to extend interest-free loans as well as tax exemptions to small businesses with no more than 10 employees. Similarly, the CBI issued the SME Finance Company Ordinance of 2010 explicitly allowing commercial companies

(SME Finance Companies) to engage in lending activities for SMEs, which can include micro-enterprises. However, SME Finance Companies are not permitted to collect deposits. Despite this Ordinance, no companies have to date been created. While some NGO MFIs have expressed interest in establishing such companies, they have not been allowed to do so. Although NGO MFIs are registered with the NGO Directorate under the NGO Law, the Central Bank of Iraq (CBI) arguably has the authority to regulate and supervise them as financial institutions and may be better suited to do so. Another challenge is the lack of a level playing field due to different rules that apply to Iraqi NGOs, Kurdistan NGOs, and SME Finance Companies.

Additional challenges in the regulatory environment include the lack of regulations and clear guidance on (i) consumer protection; (ii) credit information sharing, (iii) leasing and secured transactions, (iv) and loan recovery. To summarize:

- There are no consumer protection regulations for financial services in Iraq. While banks and financial institutions are subject to bank secrecy and privacy provisions under the banking law, the NGO law does not contain any similar provisions. The twelve NGO MFIs have signed a code of conduct pledging commitment to consumer protection, but the code is not enforceable and depends on the goodwill and social responsibility of each NGO MFI.
- In addition, only licensed banks are permitted to participate in the CBI's credit registry, which has a threshold of 25 million Iraqi Dinars (the equivalent of US\$ 21,255). There is no effective credit information sharing system in place for other financial institutions, including NGO MFIs.
- There seem to be very limited understanding of secured transactions from both public and private sector stakeholders, and the existing legal framework is not conducive to the development of this form of finance. However, according to some practitioners (e.g. Iraq Company for Bank Guarantees), some finance institutions would be willing to use various movables as collateral, provided there is the appropriate legal framework in place.
- There are no specific regulations for loan recovery that would assist banks, financial institutions, and NGOs from avoiding the lengthy court system to enforce loan contracts.

Finally, the lack of funding represents a serious obstacle hindering the growth of Iraqi 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 and Kiva. There appear to be few local investors or banks willing to lend to MFIs. Furthermore, different interpretations exist regarding the nature of profitable activities NGOs are allowed to pursue given their non-profit nature. Consistent with similar legislation in other countries, the intent of this provision is typically meant to prevent profit distribution, not to prohibit NGOs from pursuing profitable activities for sustainability and growth purposes.

One of the possible solutions to attract funding is through the transfer of the NGO MFIs' microfinance services to for-profit institutions, through a process commonly called 'transformation'. Global experience demonstrates that transformation is critical in order to access broader funding sources and to offer additional services such as deposits and transfers that may be outside of the legal purview of an NGO. There is currently a lack of clarity regarding how an NGO MFI can transfer its microfinance services to either an SME Finance Company or another for-

profit company. The NGO law as written does not prohibit an NGO from selling its loan portfolio to a company in exchange for shares or money, provided that proceeds of the sale are used in accordance with the NGO's mission and that no personal gain is accrued from the sale by the NGO's members/founders and employees.

Key Recommendations

While the microfinance sector in Iraq has contributed to economic development by offering low-income individuals access to quality financial services not offered by conventional financial institutions, more households could be reached and better financial services provided if key bottlenecks impeding the sector's growth were lifted. The current legal framework could be favorable to the development of the Iraqi microfinance sector if the provisions of the law are interpreted according to international practices.

Short-Term Recommendations

- Clarify permitted and prohibited activities under the NGO Law.
- Determine the appropriate government agency to regulate and supervise NGO MFIs. It is recommended that the CBI supervise and regulate NGO MFIs. The central bank may be better placed to understand linkages between different financial institutions and ensure that prudential and non-prudential rules are evenly applied to all financial service providers.
- Clarify the legal process through which transformation of NGO MFIs can take place and develop appropriate circulars providing guidance on the transformation process.
- Amend the SME Finance Companies Ordinance by, inter alia, reviewing capital requirements and limitations on debt (currently set at 300% of capital) and restrictions on local and foreign donations.

Medium-Term Recommendations

- Conduct a demand study to assess current demand among the poor and low-income populations for financial services (savings, credit, payments, transfers, and insurance).
- Adopt financial consumer protection rules and apply them to all financial service providers.
- Establish a comprehensive credit information sharing system. A well-run credit bureau can provide financial institutions with an inexpensive means of assessing the creditworthiness of borrowers and can bring down the cost of lending in the sector.
- Encourage bank downscaling, particularly with respect to banks using agents (e.g. individuals, legal entities).
- Shift the government's role in the microfinance sector from funding provider to facilitator through gradually eliminating direct funding schemes that provide below-market or

interest-free loans. Such government interventions create market distortion due to unfair competition.

- Permit MFIs to be agents of insurance companies.
- Establish a fast track process for loan recovery. Summary procedures should be introduced in cases of simple contract enforcement/debt collection.
- 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.

I. INTRODUCTION

1. A well-functioning and inclusive financial sector is critical for efficient resource allocation leading to increased productivity, greater investment, higher overall levels of economic growth, and lower inequality. This is particularly critical in Iraq, where years of political instability and violence have impeded the development of a robust private sector. More specifically, financial inclusion – defined here as the proportion of individuals with access to quality formal financial services including credit, savings, and insurance services – is critical for improving household welfare by spurring economic activity and helping the low-income manage economic shocks. All this explains why microfinance has, in recent years, become an important development mechanism at the global level.

2. However, microfinance services in Iraq are still nascent and far from meeting their full potential. This diagnostic report aims to present the microfinance landscape in Iraq, its legal and regulatory framework, and potential policy improvements to enhance the operating environment. It aims to inform public and private sector stakeholders on the regulations and laws affecting the development and strategic direction of the microfinance sector. The policy recommendations presented here are designed to address factors preventing greater growth and outreach, with the goal of promoting inclusive financial sector development in Iraq.

II. MACROECONOMIC FRAMEWORK, FINANCIAL SECTOR, AND MSMEs IN IRAQ

A. Macroeconomic Framework

3. Iraq's economic and financial performance continues to be largely dependent on the performance of the oil sector. Revenues from oil account for about two-thirds of Iraq's GDP and for almost all export and fiscal revenues. Government oil revenues accounted for 60% of GDP in 2014, comprising 90% of total government revenue.¹

B. Financial Sector²

4. Although the banking sector accounts for more than 75% of the assets of the Iraqi financial system, it remains small. The 2012 World Bank report indicates that the banking sector has total assets of US\$ 61 billion (IQD 71 trillion).³ This amounts to an asset to GDP ratio of 73%, which is significantly lower than the ratio for the MENA region of 130%.⁴ Domestic credit to the private

¹ 2014 UNDP Human Development Report.

² The following discussion of the banking sector draws from the 2012 World Bank document: "Republic of Iraq: Financial Sector Review."

³ The official figure is IQD 329 trillion (US\$ 282 billion), equivalent to 318% of GDP. The World Bank report indicates that this larger figure includes large exchange rate valuation losses on the banks' balance sheets.

⁴ In turn, the ratio for the region is low when compared with other regions. Of the EU-15 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom), the ratios ranged from 164% (Italy) to 1,619% (Luxembourg) with the next two highest countries being Ireland (625%) and the United Kingdom (521%). (Figures – which are for June 2011 – are based on the European

sector only amounted to 6.2% of GDP in 2012⁵ – lower than every country (according to the World Bank data) except Yemen. For comparison, domestic credit to the private sector is 92.2% in Lebanon, 72.4% in Jordan, and 29.7% in Egypt. As a corollary, banks are very liquid; foreign assets and deposits at the Central Bank of Iraq (CBI) amount to 63% of assets. The banking sector is dominated by seven State-owned banks holding, in the aggregate, 86% of bank assets and 69% of credits. There are 47 private banks registered with the CBI, 15 of which have foreign participation, and nine of which are Islamic. These banks are small and their loans are primarily short-term loans for wholesale and retail trade.

5. The remaining segments of the Iraqi financial system are underdeveloped. Iraq's stock market is nascent, with a total market of around US\$ 3 billion (IQD 3.5 trillion).⁶ The same applies to the size of the insurance market, for which no precise data is available. No data is available for the Postal Saving Fund, exchange companies, financial transfer companies, or other non-bank financial institutions (NBFIs), except for the MFIs. Notwithstanding a 2010 CBI Ordinance establishing a new type of NBFI – the SME Finance Company – there are no such companies operating today.

C. MSMEs and Access to Finance

6. The number, size, and distribution of the Iraqi MSME sector are difficult to measure due to the lack of available information. A 2005 ILO estimate put the total number of registered SMEs with 3 or more employees at 622,000, self-employed entrepreneurs at 719,000, and estimated one million unregistered MSMEs. Data on the size distribution of firms and their contribution to GDP and employment is not captured in official statistics.

7. According to a 2010 USAID survey, access to finance, especially for working capital or operational costs, is the most limiting constraint for MSME development, ahead of both security and energy shortages.⁷ A USAID project team estimated that fewer than 5% of SMEs in the formal sector have ever received a bank loan.⁸ This is largely due to the loan terms, which are not appealing to MSMEs: the repayment terms are too short and the collateral requirements exceed the loan amounts.⁹ Further exacerbating the problem are bankers' limited experience in lending to MSMEs and general lack of technical skills in analyzing credit risk and conducting cash-flow analysis.

Central Bank and national central banks and the IMF World Economic Outlook Database, as presented in an October 2012 [Policy Paper](#)).

⁵ <http://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS>. According to the website, “Domestic credit to private sector refers to financial resources provided to the private sector, such as through loans, purchases of non-equity securities, and trade credits and other accounts receivable, that establish a claim for repayment.”

⁶ The Iraqi Stock Exchange (ISX), founded in 2004 with 15 companies listing their shares, already compares well with other regional exchanges in terms of the number of listed companies. The banking sector is the largest on the stock market, which also lists industrial, agricultural, and insurance firms. The total market value of shares listed on the exchange is around US\$3 billion and the daily trade volume averages from US\$2 million to US\$3 million (USAID 2011).

⁷ Tijara Project, Access to Finance by Micro, Medium and Small Enterprises in Iraq, July 31, 2010.

⁸ 2012 World Bank report.

⁹ 2012 USAID report “State of Iraq’s Microfinance Industry.”

III. THE MICROFINANCE LANDSCAPE IN IRAQ¹⁰

8. *Government programs.* In 2007, the Ministry of Labor and Social Affairs (MoLSA) started providing loans. Pursuant to a 2012 law that established an IQD 150 billion fund (US\$ 129 million) for loans ranging from IQD 5 to 20 million (US\$ 4,300-17,000), it is currently implementing a new SME loan program.¹¹

9. *Non-governmental organization microfinance institutions (NGO MFIs).* The Iraqi microfinance sector started in 2003, under the impulse of the USAID-Izdihar program, later followed by USAID-Tijara, both being instrumental in funding and scaling up NGO MFIs. MFIs offerings have thus far been limited to microcredit and, to a much lesser extent, basic micro-insurance services. During the first half of 2015, their cumulative outstanding portfolio was estimated at a total of US\$ 144 million (IQD 171 billion), equivalent to less than 1% of the banking sector's assets.

Table 1: MFIs and commercial banks in Iraq as of 2015

Indicators	MFIs	Banks
Number	8 MFIs in operation (out of 12)	State (7); private banks (47)
Number of Branches	~85 outlets	State (391); private banks (383)
Loan Size	US\$ 500-25,000	For SMEs about US\$ 15,000 at disbursement
Repayment Period	18 months	Typically < 2 years
Collateral Requirements	1) Government Employee guarantees 2) Solidarity Group: peer to peer	Usually physical collateral if > US\$ 10-15,000
Services Offered	1) MSME Loans 2) Agri-business Loans 3) Housing Loans 4) Trade Loans 5) Taxi Loans 6) Educational Loans 7) Qard Hassan (interest-free loans)	Overdraft, trade finance, deposits and money transfers, loans and guarantees
Loan Processing Time	2-3 Days	Highly variable, usually 30 to 60 days, but in some cases much less and in others much more

Source: USAID Iraq's State of Microfinance 2012; Iraq Microfinance Network.

Note: Banks presently charge an effective interest rate of 10-13%; based on portfolio yield, MFIs charge an estimated effective rate of 20-30%, which is in line with international and regional median rates.

10. The Iraqi microfinance sector remains one of the smallest and least developed in the MENA region in terms of penetration as a percentage of the overall population. However, it has grown to become a noticeable part of the microfinance industry in the MENA region due to its

¹⁰ Unless otherwise stated, figures are extracted from the "State of Iraq's Microfinance Industry", USAID-Tijara, October 2012 or provided by the Iraqi Microfinance Network at the latest available date.

¹¹ In addition, there are two institutions, owned by commercial banks, providing and guaranteeing loans to SMEs: The first is the Iraqi SME Finance Company, which was established in 2009 and disbursed about 3,900 loans, with a portfolio of US\$ 62 million and created about 6,000 jobs (directly and indirectly). The second is the Iraqi Bank Guarantees Company, which was established in 2006 with CBI's support and guaranteed about 7,864 loans with an accumulated portfolio of IQD 90 billion (US\$ 75.6 million).

portfolio size (as opposed to outreach), which is a product of the relatively high average loan size (US\$ 1,700) and the large population (33 million in 2013).

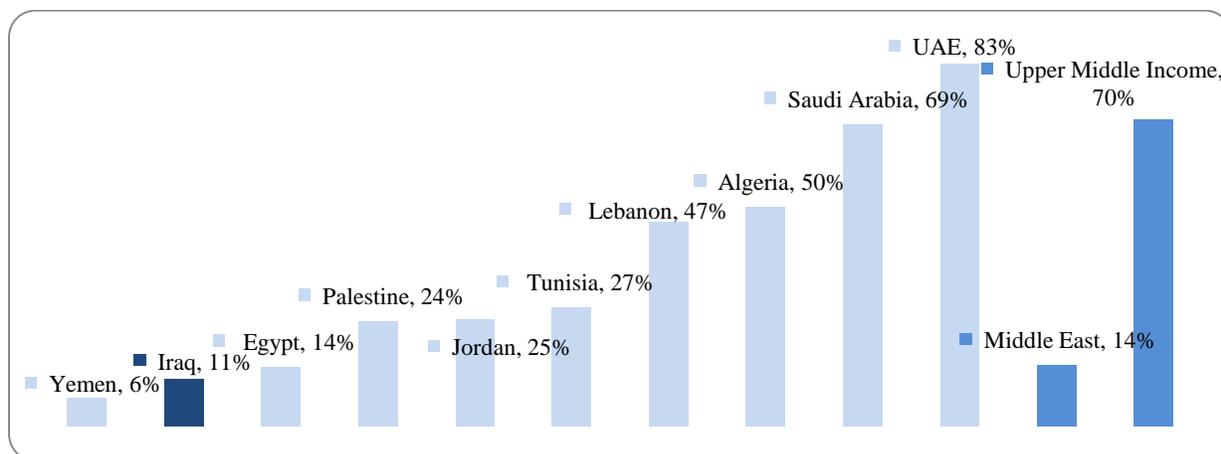
11. Microcredit in Iraq is typically segmented into three product types based on the loan size: up to US\$ 500 reaching the very poor, US\$ 500-5,000 reaching micro-enterprises, and US\$5,000-25,000 reaching small enterprises. In comparison to bank loans, NGO MFIs provide much quicker loan processing (within days) and generally do not require onerous collateral requirements. Most NGO MFIs accept guarantors or use solidarity groups as a form of social collateral.

A. Demand for Microfinance

12. There is limited information on the demand for microfinance products and services in Iraq including credit, savings, insurance, payments, or transfers. Market potential has never been precisely addressed, but untapped demand is likely to be sufficiently large given the 7.36 million poor (22% of the population), out of which 2.5 million are economically active (8% of the population).¹²

13. While there is no household survey data that captures the demand and/or usage of financial services, Iraq was part of the 2011 and 2014 Global Financial Inclusion Survey (Global Findex)¹³, which measured how people in 148 countries – including the poor, women, and rural residents – save, borrow, make payments and manage risk. The results of the survey confirm the findings of smaller surveys, i.e. that access to financial services for households and microenterprises is very low in Iraq, both by regional and income group standards. According to Global Findex, in both 2011 and 2014, only 11% of households of the adult population in Iraq had access to an account at a formal financial institution. In 2014, this was one of the lowest levels in the Arab world, and significantly below the income group average (70%).

Graph 1: Account at a formal financial institution (% age 15+)



¹² Source: IMFN 2012 report, based on Confronting Poverty in Iraq 2011 Report by World Bank and Government of Iraq.

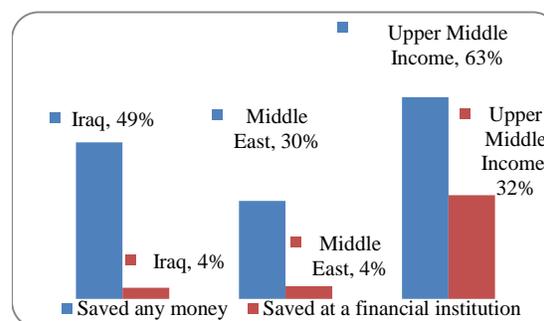
¹³ The Findex data is based on a representative sample from each country. The sample size in Iraq comprised 1,000 individuals. MENA only includes developing countries in the region. Some measurement errors might exist, but trends and cross-country comparisons are useful.

Source: Findex (2014); Middle East comprises Egypt, Iraq, Jordan, Lebanon, Palestine, and Yemen.

14. Access to formal financial services is even more limited for certain segments of the population, particularly for women and people in rural areas. In 2014, an estimated 7.4% of female adults in Iraq had access to an account at a formal financial institution (compared to 14.6% of male adults), which is well below the regional and income group average.

15. Data collected on the savings behavior of the Iraqi population indicates that these low account holding figures are not a reflection of a lower propensity to save. A relatively high percentage of adults in Iraq have reported some savings over the year prior to the 2014 survey (48.6%), above the regional average (32%), but below the income group average (62.7%). However, only 7% of these savings went into a formal financial institution, twice less than the average in the region and seven times less than comparable upper middle income countries (Graph 2).

Graph 2: Share of adults who saved money over the past year (%)



Source: Findex (2014).

16. A similar pattern is observed when it comes to borrowing. While 69% of adult Iraqis reported to having borrowed over the period prior to the 2014 survey – higher than the regional and income group average (Table 2) – less than 5% of borrowed amounts, an extremely small fraction, came from a formal financial institution. Informal sources of credit such as family, friends, or store owners are a more important source of financing to Iraqi adults than in other MENA and/or upper middle income countries (Table 2).

Table 2: Share of adults who had a loan over the past year (%)

Indicator	Iraq	Middle East	Upper middle income
Loan in the past year (% age 15+)	69.4	45.7	37.7
Loan from a financial institution in the past year (% age 15+)	4.2	5.6	10.4
Loan from a private informal lender in the past year (% age 15+)	19.8	7.9	2.6
Loan from family or friends in the past year (% age 15+)	48.2	30.7	24.0
Loan through store credit in the past year (% age 15+)	33.4	18.9	5.0

Source: Findex (2014).

17. These findings indicate that there is a significant demand for financial services in Iraq – both on the savings and credit sides – that remains unmet by the formal financial sector.

B. Supply of Microfinance

Microcredit

18. As noted above, bank credit in Iraq is low in general and non-existent at the micro level. As of October 2012, MoLSA reported 73,323 loans disbursed at subsidized rates (0%-2%) over 2007-2009, but there is no available information on its current outstanding clients. Aside from MoLSA, the only providers of credit at the micro level are the NGO MFIs. During the first half of 2015, 8 MFIs out of the 12 initially created under the USAID programs were serving about 82,000 active clients (1.1% of the poor population)¹⁴, throughout Iraq's 18 provinces. All MFIs lend in United States dollars and leave the foreign exchange risk to the client.

19. Similar to their regional peers, up to 2013, Iraqi MFIs could be divided in two categories: the large and fastest-growing MFIs, showing strong portfolio quality and profitability; and the smaller MFIs, witnessing much lower growth rates and poorer portfolio quality and sustainability. As such, the Iraqi microcredit industry was and still is relatively concentrated and championed by international NGOs or their local affiliates. The largest two MFIs, CHF and Al Thiqa, manage 69% of the portfolio and 53% of the clients. This figure goes up to over 84% of the portfolio and 77% of the clients for the top four institutions.

20. Despite the difficult operating environment, the best performing Iraqi MFIs have maintained a good portfolio quality, although the industry average has deteriorated over the years, with non-performing loans over 30 days (NPL 30) estimated at around 6-7% in early 2015, up from 2.7% in December 2012, and 0.7% in December 2010. MFIs with fraud or governance issues bear the highest risk (NPL 30 above the median reported to the MIX Market of 3%-4%; above 20% for some MFIs) while other show a good repayment performance (NPL 30 below 2%).¹⁵ At the aggregated level, operating costs were significantly cut over the years, evidencing economies of scale, and sustainability levels have been positive over 2009-2013. Performance still varied significantly from one MFI to another, regardless of size, origin, or area of operations. Portfolio yields ranged from 20% to 40% over 2011-2012.

21. The sector has experienced growth over the past years, as is often the case of young microfinance industries. However, year-on-year growth rates in both outstanding portfolio and number of clients are declining: +48% and +52%, respectively, in 2009; +17% and +14%, respectively, in 2012, with a steeper decline witnessed over the second half of 2012 and 2013. Aggregated growth has since stalled, with the ongoing conflict unequally affecting operations: 4 MFIs have stopped lending, some have shrunk in size, and others have maintained their double-digit growth. Apart from the conflict, lack of funds is one of the main reasons behind this decline and will continue to be a major growth constraint going forward. Although most MFIs have historically relied on grants, there have been no new grants since September 2012. Other sources of funds are limited. NGOs cannot raise equity nor take deposits. For now, there are only two global microfinance investors supporting MFIs in the country, OPIC and Kiva. Furthermore, there appear to be no local investor or bank willing to lend to MFIs, though few MFIs have approached banks to obtain a loan (one MFI reported being offered an interest rate of 15% that was deemed

¹⁴ 21% of female borrowers in 2012.

¹⁵ Write-offs are not available, which makes it difficult to analyze the industry credit risk as a whole.

too high). NGOs are not legally prohibited from borrowing, but local banks are reluctant to lend in the absence of legally liable owners and of customary collateral.

22. The Iraq Microfinance Network (IMFN) was formally registered in April 2012 as an independent NGO. It represents all 12 NGO MFIs and is the industry body in charge of strengthening the sector through coordination, training, advocacy, and research. It aims at facilitating the dialogue between microfinance stakeholders in the country, lobbying for more favorable policies, and collecting industry data. It publishes reports analyzing the state of the microfinance industry in Iraq and organizes national conferences gathering local and international partners. It also delivers training workshops to its members.

Table 3: Microfinance providers in early 2015

Institution	Portfolio (M US\$)	Portfolio Share (%)	Cumulated Share (%)	Active Borrowers	Borrowers Share (%)	Cumulated Share (%)
CHF	70.7	49%	49%	29,482	36%	36%
Al Thiqa	28.8	20%	69%	13,727	17%	53%
Izdiharuna	11.3	8%	77%	13,321	16%	69%
Bright Future Foundation (BFF)	10.0	7%	84%	~7,000	9%	77%
Al Aman	7.7	5%	89%	4,178	5%	82%
Amalkom	6.1	4%	93%	8,395	10%	93%
Relief International	5.3	4%	97%	2,873	3%	96%
Al Bashaer	4.3	3%	100%	3,152	4%	100%
Al Takadum *	0.0	0%	100%	0	0%	100%
Tallafar Economic Development Center*	0.0	0%	100%	0	0%	100%
Al Mosaned*	0.0	0%	100%	0	0%	100%
Al Tadamun *	0.0	0%	100%	0	0%	100%
Total	144.1	100%		82,128	100%	

* Had stopped lending in 2015.

Source: IMFN, at the latest available date in 2015; figures are to be considered as estimates.

23. Compared to other countries in the region, the Iraqi microcredit industry has one of the lowest outreach rates relative to its total population.

Table 4: Microcredit outreach in the Arab world

Country	Portfolio (M US\$)	%	Active Borrowers	%	Population (Millions)
Morocco	577	33%	814,860	28%	32.3
Egypt	276	16%	~1,100,000	38%	82.5
Jordan	254	14%	299,964	10%	6.2
Palestine	150	8%	49,973	1.7%	7.5
Iraq	149	8%	88,480	3.0%	33.4
Tunisia	126	7%	254,904	8.8%	10.7

Lebanon	117	7%	99,804	3.4%	4.3
Sudan	64	4%	64,913	2.2%	34.3
Yemen	49	3%	105,626	3.6%	24.8
Syria	10	1%	29,266	1.0%	20.8
Arab World	1,772	100%	2,907,790	100%	257

Source: MIX Market, CGAP data, latest available figures.

Insurance

24. Insurance is virtually non-existent in Iraq, with the overall supply to end clients limited to basic car insurance services.

25. According to IMFN, there have been some attempts to provide micro-insurance services, but no viable product has emerged so far due in part to a lack of understanding of the needs of poor and low-income customers and to a general lack of understanding of insurance practices. A Lebanese-based insurance company, Commercial Insurance, has nonetheless been providing credit life insurance policies since 2012 (currently to CHF and Amalkom, initially to Relief International and Izdiharuna as well, but the contract was not renewed).

26. In the light of increasing credit risk, some MFIs have sought guarantees for their loan portfolio. Al Aman had contracted the National Insurance Company, a local company, but later discontinued the contract. Other MFIs, including Al Bashaer, tried to close a deal with the Iraqi Company for Bank Guarantees, a company set up by USAID, but were not satisfied by the offer.

Payments and Transfers

27. Data was not available on payments and transfers. To date, no work has been done on any kind of payment service (e.g. mobile phone-based, cards) for low-income consumers.

IV. LEGAL AND REGULATORY FRAMEWORK FOR MICROFINANCE SERVICES IN IRAQ

A. The basic laws governing financial institutions

28. The laws and regulations of primary relevance to Microfinance in Iraq include: 1) the Central Bank Law, 2) the Banking Law and the prudential regulations adopted thereunder, 3) the Support of Small Income-Generating Projects Law, 4) the Insurance Law, 5) the NGO Law, 6) the Iraqi Kurdistan Region NGO Law of 2011, 7) the Council of Ministers Instruction (#6 from 2010) on implementation of the NGO law, and 8) the SME Finance Companies Ordinance.

The Central Bank Law and the Banking Law

29. The CBI was established as an independent monetary policy regulator¹⁶ and is responsible for promoting a competitive, stable and market-led financial system. Under the Central Bank Law and the Banking Law, the CBI is responsible for licensing, regulating, and supervising banks as

¹⁶ The CBI was established under the Central Bank Law of 1976 which was repealed and replaced by the Central Bank Law of 2004.

well as lending companies. The Central Bank Law also provides that “the CBI may take whatever action it deems necessary to regulate and supervise lending companies, microfinance companies, and any other non-bank financial institutions not otherwise regulated under Iraqi law” (Article 4).¹⁷ Although NGO MFIs are registered under the NGO Law, the CBI arguably has the right to regulate them as financial institutions.¹⁸

30. The Central Bank Law also gives the CBI responsibility over the national payment system and payment service providers.

The Support of Small Income-Generating Projects Law

31. In 2012, the Parliament passed the Support of Small Income-Generating Projects Law. Besides giving interest-free loans with the maximum limit of IQD 20 million for each loan (US\$ 17,000), the law also aims to create jobs, reduce unemployment, build capacity, and simplify the registration procedures of small projects.¹⁹ The law created a Fund with a capital of IQD 150 billion (US\$ 129 million) paid by the government, and exempts all small projects created under this law from income tax and government fees.²⁰

The Insurance Law

32. The Insurance Law was approved in 2005 and aims at regulating and supervising the insurance sector to enable it to grow and develop to create a free, secure, and transparent market in the country. The law clearly states that insurance services can only be provided by entities licensed by the insurance regulatory authority, Al-Diwan. Insurance companies are required to notify Al-Diwan before opening, closing or relocating branches. All insurance companies are subject to a set of requirements including minimum capital (set by regulation), “fit and proper” requirements for the management, and auditing and reporting requirements that guarantee their safety and soundness. According to the law, and in order to protect insurance policy holders, all insurance companies must deposit an amount, as approved by the head of Al-Diwan, in a licensed Iraqi bank as a guarantee for the payment of any future claims and liabilities.

33. Insurance agents are subject to separate licensing requirements and procedures under a special instruction. An agent acting on behalf of insurance companies must be licensed by the regulator. With respect to credit life insurance, an NGO MFI has a contractual relationship with the insurance company but is not an agent.

¹⁷ The CBI has a separate department for each type of institution that it regulates and supervises. According to the 2011 World Bank Iraq Financial Sector Review report, at that time, the CBI supervised over 40 banks and over 1,750 other financial institutions, including MFIs, exchange bureaus, money transfer services, and investment companies.

¹⁸ It is unclear whether the CBI can regulate an NGO under the current laws. Resolution of this issue would require a discussion between the NGO Directorate and the CBI.

¹⁹ The Support of Small Income-Generating Projects Law defined a “small project” as an income-generating project with no more than 10 employees.

²⁰ Article (15) of Support of Small Income-Generating Projects Law.

The NGO Law of 2010, the Iraqi Kurdistan Region NGO Law of 2011, and the Council of Ministers Instruction #6 of 2010

34. A new NGO law (n°12) was approved in March 2010. It allows the registration of both national and international NGOs under the supervisory umbrella of the NGO Directorate. There is no explicit reference to NGOs operating as MFIs (and there is no prohibition, as the previous law implied).²¹ Under the new law, NGOs previously registered are required to undertake a new registration and to conform to all the new rules and requirements.²² The law sets forth procedures for the registration of NGOs²³, but the process is often cited as burdensome and time-consuming. The law places more emphasis than the former law on good governance and transparency rules and requirements. These include yearly financial report to the NGO Directorate including a detailed description of the sources of the NGO's funds and financial transactions, a report on the NGO's activities including a briefing on the projects implemented during the year, and an annual audit report by an approved auditor. There are currently about 2,400 registered NGOs in Iraq. The law does not specify a usury rate, but some MFIs report pressures to charge a maximum flat rate of 15% per annum, inclusive of all fees.

35. The Iraqi Kurdistan Region Parliament approved a separate NGO Law in 2011. NGOs registered under the Iraqi Kurdistan Region NGO Law are allowed to operate only in the Kurdistan region and are exempted from taxes and customs duties. NGO MFIs registered under the Iraqi NGO Law are permitted to operate in all regions, including Kurdistan; however, they are required to pay all taxes, VAT and custom duties (and therefore theoretically operate in the Kurdistan region at a financial disadvantage in terms of post-tax income).²⁴

36. In 2010, the Council of Ministers adopted the Instruction #6 related to the NGO Law implementation. It states that “NGOs are prohibited from practicing... commercial activities” (Article 8).

The SME Finance Companies Ordinance of 2010

37. By adopting this Ordinance, CBI explicitly allowed commercial companies (SME Finance Companies) to engage in lending activities for SMEs. SME Finance Companies are not permitted to engage in deposit-taking. There is no definition of “SME” in the Ordinance, nor has any definition been issued by the CBI or any other government authority.

38. Although it was originally drafted to address both micro and SME issues, the final version addresses only SME Finance Companies, though the instructions include references to MFIs. The SME Ordinance includes some key requirements:

²¹ In fact, there is no legal provision in the NGO Law or any other law that defines the term “microloan” or “microfinance institution.”

²² As of June 2013, Relief International had not yet received its registration under the new law.

²³ These include minimum qualifications and number of the founding members. There is no minimum capital required and offices can be opened in all Iraqi provinces.

²⁴ It is to be noted that there are no implementing regulations stipulating tax rates. Additional information on tax treatment (e.g. whether special deductions permitted for banks and other finance companies – if any – are permitted to be deducted by NGO MFIs) is unavailable.

- A relatively high minimum capital requirement: two billion IQD or the equivalent of US\$ 1.7 million for a joint stock company (JSC) and one billion IQD or the equivalent of US\$ 860,000 for an LLC;²⁵
- Board members must be residents of Iraq, which may be problematic for foreign investors;
- Companies should get the approval from CBI to open, close, relocate, or merge branches;
- Companies should get the approval from CBI to determine the minimum and maximum amount of credit offered to their clients;
- All loans should be to SMEs projects (i.e. for business purposes only);
- Companies are not allowed to borrow from local or foreign banks more than 300% of their capital;
- Companies are allowed to issue bonds up to only 50% of their capital;
- Companies should ask for the approval of the “relevant authorities” (not defined in the Ordinance or elsewhere) before accepting any local or foreign donations;
- All loans should only be given to Iraqi citizens and legal entities;
- There are provisioning requirements to be determined by CBI;
- The regulation uses the term “concessionary interest rates” but does not specify if CBI will set any cap on interest rates; the instructions state “*interest rates must be calculated according to international best practices to cover operational and financial costs*”;
- Reporting requirements to the CBI include: financial resources, loan portfolio, interest rates, loan purpose, credit methodology, required guarantees, and statement of amounts allocated to the provisions required.

B. Non-Prudential Regulation, Licensing, and Oversight

Permitted Activities

39. Licensed banks are permitted to engage in all banking activities as defined by the Banking Law, including accepting deposits from the public and mobilizing these deposits according to the rules set by the CBI, buying and selling foreign currencies, providing clearing, settlement and transfer services. Although banks may engage in micro-lending, there are no specific regulations with respect to such activities and, at this time, banks do not engage in micro-lending. Banks are prohibited from engaging in certain specified activities, including insurance underwriting and re-insurance, except on a temporary basis to satisfy a claim.

40. SME Finance Companies are allowed to engage in lending activities to SMEs, which can include micro-enterprises.

41. There is no explicit legal requirement to obtain permission to lend under the Iraqi law.²⁶ NGO MFIs, SME Finance Companies and banks are currently the only entities that engage in

²⁵ The Companies Act currently sets the minimum capital of a JSC at IQD 2 million (US\$ 1,700), the minimum capital of an LLC at IQD 1 million (US\$ 850), and all other companies at IQD 50,000 (US\$ 42). The Banking law states a minimum capital requirement of IQD 10 billion (US\$ 8.5 million), which the CBI recently increased to IQD 150 billion (US\$ 127 million).

²⁶ Both the Banking Law and Central Bank Law differentiate between two terms, the first is “Banking Business”, defined by both laws as accepting deposits from the public and using these deposits to grant credit, and the second is “Banking Activities” as stated in Article (27) of the Banking Law and included credit activities. Furthermore,

lending activities. The NGO law does not prohibit NGO MFIs from engaging in lending activities as long as there is no direct or indirect distribution of profits to their members.

Box 1: Microfinance in Yemen

In 2009 Yemen created a new tier of deposit-taking financial institutions by adopting the Microfinance Banks Law. The law does not set any restrictions on foreign investments or participations, and sets minimum capital requirements for the establishment of a microfinance bank at YER 500 million or about US\$ 2.3 million, making it very accessible. There are currently two licensed microfinance banks in Yemen. However, the political climate has made it difficult to attract foreign investors. Microfinance banks fall under the supervision of the Central Bank of Yemen who adopted specific prudential rules to suit the special nature of microfinance (e.g. limitations on transactions with related parties, the prohibition of insider lending, liquidity and capital adequacy ratios, provisioning requirements and credit risk management).

Consumer Protection

42. Banks and financial institutions (including finance companies under the SME Ordinance) are also subject to bank secrecy and privacy provisions of the Banking Law and Central Bank directives. However, there is no separate consumer protection regulation for financial services in Iraq.

43. In August 2010, the twelve NGO MFIs operating in Iraq's 18 provinces signed a Code of Conduct and Ethics which is currently being updated. The code states that MFIs have to "uphold core values such as high quality financial services, transparency, respect for religion, fair lending, and collection practices, privacy of client information and integration of social values into business decision making."²⁷ This code is not enforceable and depends solely on the MFIs goodwill as it has no legal basis, notably in case of breach. The NGO law does not contain any provisions similar to the bank secrecy and privacy provisions applicable to banks.

Credit Reporting

44. Only licensed banks are permitted to participate in the CBI's credit registry (they are also required to participate), which has a threshold of IQD 25 million (US\$ 21,255). There is no effective credit information sharing system in place for other financial institutions, including NGO MFIs. The Banking Law allows banks to create credit information agencies that collect and share information concerning the financial affairs of customers (existing and prospective) with banks (and only banks). Credit information about a person that is held by such an agency or bureau may be furnished only to a bank that has a current or prospective customer relationship with the subject

Article (3) of the Banking Law prohibited any person from engaging in any "Banking Business" without obtaining a license from CBI, which means that credit activities is not included in the prohibited activities, as stipulated in Article (3), and should not be treated as a "Banking Business" thus do not require the license of CBI. Moreover, Article (3/2/a) of the Banking Law excluded persons who fund credit from non-refundable capital subscriptions or credit received from financial.

²⁷ <http://www.imfi.org/en/node/179>

of the information. When sharing any credit information, banks must at all times abide with the rules adopted by the CBI pursuant to the Banking Law.²⁸ Today, there is no such private credit bureau operating in Iraq. According to the CBI, SME Finance Companies may be allowed in the future to participate in the CBI's credit information system.

45. The only source of credit information for MFIs was a blacklist system (no longer operating) established on the Iraqi Microfinance Knowledge Portal, giving authorized users the possibility to manage and search a database of blacklisted borrowers.²⁹ The system was intended to serve MFIs' needs to identify delinquent and defaulting clients, although the total or defaulted loan amount was not stored in the database and there was no mechanism for clients to access information on them, file a complaint on inaccurate or outdated data, or correct it.

Limitations on Ownership, Management, and Capital Structure

46. According to the Iraqi laws,³⁰ except with respect to banks, there are no limitations on foreign ownership of commercial companies in Iraq. Non-Iraqis are allowed to (i) possess, use, and dispose of their investment, (ii) manage or participate in managing a business entity, (iii) transfer their rights and obligations, and (iv) transfer dividends, profits, and investment proceeds to their home country.³¹ There are some restrictions on foreign investment in the banking sector. Foreign individuals and entities are allowed to own a maximum of 10% of a licensed bank in Iraq. These limitations do not apply to licensed foreign banks who are allowed to participate in licensed Iraqi banks if they are, among other conditions, supervised by the national regulatory and supervisory authority of their home country.³² Foreign banks are allowed to open branches and representative offices in Iraq.³³ There are no restrictions on foreign ownership of NBFIs³⁴ and according to CBI's SME Finance Companies Ordinance there are no restrictions on foreign investment. Moreover, the NGO Law allows foreign NGOs to operate in Iraq after acquiring the proper license.

Governance

47. The Banking Law sets minimum "fit and proper" requirements for the board members of a licensed bank, including a requirement for the majority of members to have strong banking experience, and full and complete disclosure of interests that would constitute a conflict of interest. All banks are required to abide by the minimum governance rules and requirements stipulated by

²⁸ Paragraph 2 of Article (39) of the Banking Law No. 94 of 2004.

²⁹ According to IMFN, the service was not useful due to limited data upload, notably because many MFIs work in areas with little competition.

³⁰ Article (12) of the Companies Law of 1997 stated: "A juridical or natural person, foreign or domestic, has the right to acquire membership in the companies stipulated in this law as founder, shareholder, or partner, unless such person is banned from such membership under the law, or due to a decision issued by a competent court or authorized governmental body." Ministerial Instruction No. 196 dated March 15, 2004 and Ministerial Instruction No. 149 dated February 29, 2004 stressed that in more details.

³¹ Despite the absence of legal restrictions on cash movements, the NGO Directorate recently asked its audit arm to investigate an outgoing international transfer by an MFI.

³² Article (4) of the Banking Law No. 94 of 2004 and Article (3) of the Implementing Regulations of the Banking Law No. 94 of 2004, issued by the CBI on January 2011.

³³ Article (6) of the Banking Law No. 94 of 2004.

³⁴ Article (8) of the Implementing Regulations of the Banking Law No. 94 of 2004, issued by the CBI on January 2011.

the CBI's prudential regulations. The law also required setting reliable internal and external auditing procedures.

48. The SME Finance Companies Ordinance sets some minimum requirements for board members, to ensure the companies are managed according to the law and CBI's instructions. All board members must be "fit and proper" and enjoy good reputation, cannot sit on the board of another Iraqi company or bank, and must reside in Iraq. The board must include at least three members with banking, financial or legal expertise and a university degree. Moreover, the governor of the CBI has the right to supervise the qualifications of the companies' officers according to a set of rules to be adopted by the CBI.

49. The NGO Law sets some basic governance requirements, mainly by requiring members to avoid and disclose any conflict of interest. The MFIs' Code of Ethics and Conduct includes governance provisions that refer to board members (i.e. that they have a good and sound reputation and that the majority of them are independent and/or duly elected representatives of the community that the MFI serves), transparency in the maintenance of books and accounts, and reporting with respect to compliance with the Code of Ethics and Conduct. For local NGOs, 25% of the board members may be foreign but any board member must be resident or have a one-year visa. For foreign NGOs, there is no such restriction.

Secured Transactions

50. The banking system is heavily collateralized, and in a predominant number of cases, real estate is the preferred type of collateral, with motor vehicles sometimes used as collateral as well. Other types of movable properties, such as equipment/machinery, accounts receivable, and inventory are not used to secure payment obligations.

51. There seem to be very limited understanding of secured transactions from both public and private sector stakeholders, and the existing legal framework is not conducive to the development of this form of finance. However, according to some practitioners (e.g. Iraq Company for Bank Guarantees), some finance institutions would be willing to use various movables as collateral, provided there is the appropriate legal framework in place.

Loan Recovery Framework

52. There are no specific regulations for loan recovery that would assist banks, financial institutions and NGOs from avoiding the lengthy court system to enforce loan contracts. According to the World Bank publication "Doing Business 2014", Iraq ranks 142 out of 189 in contract enforcement, compared to the MENA average rank of 118.³⁵

Financial Crime/AML/CFT

53. The CBI is authorized to take any action it considers necessary to counter money laundering and the financing of terrorism.³⁶ External auditors need to certify whether or not adequate measures have been taken by banks to prevent money laundering or the financing of

³⁵ Financial Sector Review of the Republic of Iraq, World Bank 2012.

³⁶ Article 4(2) of the Law on the Central Bank of Iraq.

terrorism. Other financial service providers (e.g. money transfer offices and exchange bureaus) are also under the supervision of the CBI.

54. The Anti-Money Laundering Act of 2004 applies to all transactions above US\$ 10,000 (above the range of microloans but within that of SME loans). According to the World Bank Financial Sector Review (Sept. 2011), a revised draft law provides that the CBI will establish an Anti-Money Laundering Bureau, but there has been no change to the status of the draft law to date.

55. Iraq was subject to a FATF-MENA AML/CFT Mutual Evaluation in 2012. It was classified under the “High-risk and non-cooperative Jurisdictions” in June 2013.

C. Prudential Regulation

56. Typically, prudential regulation is applied to banks and other deposit-taking institutions *but not* to lending-only institutions as they use only their own capital and borrowed funds rather than public deposits.³⁷ However, some regulators do apply prudential regulations (although perhaps a limited range) to credit only institutions. This may be advisable if the institutions are sufficiently large in terms of total loan portfolio and number of clients. In Iraq, there are no deposit-taking microfinance institutions, but the CBI has applied certain prudential regulations to SME Finance Companies (initial minimum capital requirement, debt to equity limitations, provisioning, reporting). There are no prudential regulations applicable to NGO MFIs.

Capital Adequacy

57. The CBI has set a minimum risk-weighted capital adequacy ratio for banks of 12% based on consolidated financial statements that include all branches inside and outside Iraq and subsidiaries. There is no specified risk-weighting for microloans.

58. As noted above, SME Finance Companies are subject to certain debt-to-equity requirements: total borrowings from local or foreign banks may not exceed 300% of capital, and issued bonds may not exceed 50% of capital.

Unsecured Lending Limits and Loan-Loss Provisions

59. Based on the CBI’s prudential regulation,³⁸ loans are classified quantitatively, in terms of time overdue, and qualitatively, based on the client’s cash flow compared to the loan/installment amount, the availability and accuracy of needed information about the client’s business and financial capabilities, the reputation and experience of the client’s management team, and the accuracy of the true market value of guarantees. There is, however, no specific instruction regarding provisioning for microloans. Performance on these indicators determines the loan classification which is based on five categories: “good”, requiring no provisions; “average”, overdue more than 30 but less than 90 days, and other criteria, requiring no provisions; “below

³⁷ The owners or founders, grantors and lenders of these non-depository institutions are presumed to monitor the activities and ensure that the funds are not being subject to undue risk of loss.

³⁸ The Implementing Regulations of the Banking Law No. 94 of 2004, issued by the CBI on January 2011.

average”, overdue more than 90 but less than 180 days, requiring 20% provisions; “doubtful”, requiring a provision of 50%; and “bad”, requiring a 100% provision. The regulations did not yet set limits on unsecured lending.³⁹

60. The above requirements apply to banks only and not to NBFIs (e.g. SME Finance Companies). The SME Finance Companies Ordinance states that provisioning requirements for SME Finance Companies shall be determined by the CBI. There was no information available to determine if the CBI issued any requirements.

Liquidity and Foreign Exchange Risk

61. Banks are required to adopt adequate and reliable policies and procedures to control liquidity, foreign exchange, and other risks. Banks must report their liquidity forecasts to the CBI on a daily basis and make sure that the minimum ratio between assets and liabilities, in all currencies, maturing within a week is according to the ratio set by the CBI.

62. SME Finance Companies are only allowed to extend loans in IQD. The law does not set any requirements for liquidity and foreign exchange risks.

Loan Documentation

63. Banks are required to keep all documents related to clients and their transactions for a minimum period of seven years.⁴⁰ Banks are allowed to electronically archive any documents after getting the approval of the CBI to ensure of the reliability of the archiving system. The SME Finance Companies Ordinance does not state any minimum loan documentation requirements with the exception of having a clear loan contract that discloses the “true interest rate” (not defined) for the client.

Maximum Loan Amount

64. A bank may not extend loan(s) exceeding 15% to 20% of its capital to any person, with a maximum of 10% for related parties. There is no such limitation for SME Finance Companies.

Branching Requirements

65. Both banks and SME Finance Companies are required to gain prior approval of the CBI before opening, closing, or changing the location of any branch.

Agents and Outsourcing

66. There are no provisions in the Banking Law on banks’ use of agents or outsourcing. There are no provisions on agents or outsourcing in the SME Finance Companies Ordinance.

³⁹ According to the SEEP Framework, when not imposed by the regulator, allowance rates are based on the historical analysis of loan loss rates. They vary according to the loans past due by age: 0%-10% for 1-30 days; 0%-30% for 31-60 days; 0%-50% for 61-90 days; 25%-75% for 91-180 days; 75%-100% for 181-365 days and over.

⁴⁰ Article (38) of the Banking Law.

Reporting

67. Under the Banking Law, the CBI has the authority to require banks and their subsidiaries to provide all such information as the CBI may request. Banks are required to submit their annual consolidated balance sheets and income statements. Banks must periodically submit to the CBI statements showing assets and liabilities, foreign currency exposures, reserve position, liquid assets, large exposures, credit to related parties and information on deposits, credit lines, credit plans, and off-balance sheet commitments.

68. As stated above, SME Finance Companies must file reports with the CBI on: financial resources, loan portfolio, interest rates, loan purpose, credit methodology, required guarantees, and statement of amounts allocated to the provisions required.

Reserves Against Deposits

69. According to the CBI's Reserve Requirement Regulation, "a bank shall maintain reserves in the form of current accounts with the CBI in Dinar and foreign currencies during the reserve maintenance period so that the average of the amount of eligible current account balances at the end of each banking day over the month and the average of the Iraqi Dinar vault cash balances collected by the commercial bank during the maintenance period month equals the reserve requirement for that period."

Insider Lending

70. Banks must have the pre-approvals of its board, as well as the CBI, for insider lending. Insider lending is defined as credit to managers and key officers, board members, their relatives (up to second degree), and related companies. The aggregate total of these credits is limited to 15% of the bank's capital.

71. According to the SME Finance Companies Ordinance, licensed companies are not allowed to extend loans to any board member, director, officer or any member of the board of any of its subsidiaries.

D. NGO Transformations

72. There is currently a lack of regulatory clarity regarding how an NGO MFI can legally "transform" its operating model into an SME Finance Company or other for-profit company.⁴¹ The current law does not prohibit an NGO from selling its loan portfolio provided that (i) the NGO uses the proceeds in its permitted activities and according to its mission and (ii) there is no direct or indirect distribution of profits by the NGO to its members, founders, or employees. The same analysis would apply to the transfer by the NGO of its portfolio to an SME Finance Company in exchange for shares. Notwithstanding this, according to at least one MFI, the NGO Directorate takes the position that local NGO MFIs are not permitted to transfer assets to a company in exchange for assets of equivalent value or for shares. This appears to be based on a

⁴¹ The legal form of an NBFIs has several advantages over the non-profit NGO form, including (i) the ability to provide a variety of financial services beyond credit (with the exception of mobilizing deposits from the public); (ii) unrestricted access to both domestic and foreign funding whether through debt or equity; (iii) the ability to distribute profits, thereby attracting private investment; and (iv) fewer restrictions in foreign participation.

misunderstanding of the law, which prohibits NGOs from engaging in commercial activities *for the purpose* of distributing funds to its members or in order to avoid taxes. Therefore, if neither of these two conditions applies, then the NGO arguably should not, under current applicable Iraqi law, be prohibited to engage in such activities.

73. One oft-cited concern about the provision of microfinance services by for-profit entities versus non-profit entities is the perceived increased risk of mission drift. The concern is that the transformed MFI would shift its focus from a public benefit purpose to instead serve the private interests of its owners, which may diverge from the original social mandate and be more profit-driven. NGO MFIs can strongly influence the orientation of the new entity by retaining an ownership interest to ensure that it continues to serve its original social mission (e.g. serving the poor). Even if the new entity decides to open its capital to new investors, it can continue to preserve its mission by ensuring that the interests of the new investors are aligned with its mission (e.g. through socially responsible investors).

Box 2: Arab countries that explicitly allow MFI transformation

- 1. Tunisia.** The Microfinance Law of 2011 that allows both NGOs and companies to engage in microfinance (Article 2) also allows NGO MFIs to own shares in/establish microfinance companies (Article 26).
- 2. Palestine.** The Microfinance Regulation of 2011 that allows for-profit and non-profit companies to engage in microfinance (Article 4 paragraph 2) also allows non-profit MFIs to own shares in/establish for-profit companies (Articles 31 & 32).
- 3. Morocco.** The 2013 amendment of the Microfinance Law allows NGO MFIs to own part or all the shares of microfinance companies (Article 1).
- 4. Egypt.** The Egyptian Microfinance Law n°141 issued in November 2014 allows both NGOs and companies to engage in microfinance, and also allows NGO MFIs to own shares in/establish microfinance companies (Article 3).

Note:

In the absence of any legal restriction, both Lebanon and Jordan allowed transformations of NGO MFIs without enacting a legislation that explicitly allows such transactions.

E. Oversight and Supervision of Non-Depository MFIs

74. Since 2010, the CBI is responsible for supervising and regulating SME Finance Companies according to the SME Finance Companies Ordinance of 2010. The NGO Directorate has the authority to oversee NGOs, including NGO MFIs. However, for reasons described above, the CBI arguably has the authority under the Central Bank Law to regulate and supervise NGO MFIs as financial institutions.

75. Although there are arguments against having a prudential regulator (such as the CBI) regulate and supervise non-depository financial institutions, in some cases it is preferable if the

only alternative is a non-financial regulator that is not familiar with financial institutions, their operations, management, and risks.

76. The NGO Directorate in Iraq has a limited understanding of MFI operations. It has not adopted special regulations for NGO MFIs and their financial activities. In fact, it has tried to impose (and in some cases, successfully impose) certain requirements on NGO MFIs that are not specified in the law, including prohibiting transfers of funds outside the country to repay a loan, requesting NGO MFIs to abide by an interest rate cap set by the NGO Directorate, and preventing NGO MFIs from selling assets to a for-profit institution. With proper training and capacity building to understand the special nature of microfinance, the CBI is well placed to act as the regulator and supervisor of MFIs given its role as financial sector supervisor. The CBI has the mandate to regulate and supervise financial institutions, which could include NGO MFIs. This would ensure a coherent and unified oversight over the same activities that are provided by financial institutions licensed by the CBI, and would allow a better support for NGO MFIs that seek to improve their governance and risk-management, paving the way for a possible transformation.

V. RECOMMENDATIONS FOR DEVELOPING MICROFINANCE IN IRAQ

Set forth below are short and medium term recommendations that aim to enhance the overall regulatory framework and operating environment for MFIs in Iraq. Overall, the current legal framework is conducive to the development of the Iraqi microfinance sector if the provisions of the law are interpreted according to international practices. Several recommendations address what appear to be misconceptions or ambiguities of applicable laws.

A. Short Term Recommendations

1. Based on international practices in interpreting the current laws and regulations, clarify the permitted and prohibited activities stated in the NGO Law. Article (1) of the NGO Law defines the NGO as an entity that is engaged in non-profit activities and Article (6) of the instructions states “it is not permissible for a non-governmental organization to engage in a profitable or political activity”. The legislation’s intention is arguably to prevent profit distribution rather than prohibiting NGOs from pursuing profitable activities for sustainability and growth purposes.

2. Harmonize rules applicable to NGO MFIs (Iraqi and Kurd) and SME Finance Companies, including:

- Disclosure: NGO MFIs should be required to file reports similar to SME Finance Companies;
- Loan provisioning: currently the CBI has not yet set the requirements for SME Finance Companies and there are no requirements applicable to NGO MFIs;
- Governance requirements: as with the boards of banks and SME Finance Companies, an MFI board should be required to include at least three members with banking, financial or legal expertise and a university degree.

3. Determine the appropriate government agency to regulate and supervise NGO MFIs. If possible under Iraqi law, it would be advisable to place the NGO MFIs under the supervision of the CBI. A number of countries have placed all financial service providers, including NGO MFIs,

under the regulatory and supervisory authority of a central bank or NBFIs regulator. There are a number of potential benefits of such an arrangement including a level playing field and clear rules of the game that are designed and applied consistently for institutions that provide the same services. In addition, the central bank may also 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.).

4. In the case of Iraq, the central bank seems to be the best placed regulator and supervisor of MFIs given its role as financial sector supervisor. In addition to the benefits of unified oversight over the same activities, the CBI would be in a better position to advise NGO MFIs that seek to improve their governance and risk-management, paving the way for a possible transformation into a finance company or even microfinance bank. If it is not possible for the CBI to regulate and supervise the NGO MFIs, then there needs to be strong coordination between the CBI and the NGO Directorate. The CBI may want to establish a dedicated unit focusing on the microcredit sector as their characteristics and oversight requires a very different approach than conventional commercial banks.

5. Amend the SME Finance Companies Ordinance. The Ordinance opened the doors for commercial lending by NBFIs, however, after three years there are still no licensed finance companies. Certain provisions could be amended in order to stimulate the growth of these companies.

- Setting a high initial minimum capital requirement is a means to avoid overburdening the supervisory capacity of CBI. However, NBFIs such as SME Finance Companies are not deposit-taking institutions and therefore should typically not require prudential regulation and supervision, which are more onerous for both the regulator and the regulated institutions. If the SME Finance Companies were numerous and large enough to be of systemic significance, then there might be an argument for imposing certain prudential requirements. Instead of setting high minimum capital requirements, the regulator can adopt, among other options, “fit and proper” requirements on the shareholders, board members and executives of these companies to control the quality of these new entrants.
- The same rationale applies to the limitations on bank debt (currently set at 300% of capital) and bonds (50% of capital), which can hinder growth. It is recommended to remove such limitations and let the lenders determine whether an SME finance company can take on the debt burden.
- Restrictions on local and foreign donations also hinder growth. There is no clear rationale for requiring government approval prior to accepting a donation.
- Branch opening, closing, and relocation are key elements to any successful finance endeavor. The prior approval requirement of new branches can help “direct” branch openings towards underserved segments. However, restrictions on closing branches often result in populations being unserved because financial institutions do not wish to risk being trapped in unprofitable locations.
- Fewer restrictions on foreign participation would help in attracting foreign investment and expertise thus advance growth and development. According to the SME Finance Ordinance, there are direct restrictions (e.g. limitations on ownership) and indirect restrictions (e.g. limitations on the citizenship or the place of residence of board members).

6. Expedite re-registration procedures for registered NGOs and the registration procedures for new NGOs. This does not require an amendment to the NGO Law.

7. Define “microloan”, “SME”, and other relevant terms in the relevant laws to avoid regulatory arbitrage that could be linked to serving the MSME segment.

B. Medium Term Recommendations

1. Conduct a demand study to assess current demand among the poor and low-income population for a variety of services including credit, savings, payments and transfers, and insurance.

2. Clarify the legal process on how an NGO-MFI can “transform” into (i.e. transfer its activities) an SME Finance Company or other for-profit company. The current state of the law does not prohibit an NGO from selling its loan portfolio or exchanging its assets provided that (i) the NGO uses the proceeds in its permitted activities and according to its mission, and (ii) there is no direct or indirect distribution of profits by the NGO to its members. The same analysis would apply to the transfer by the NGO of its portfolio to an SME Finance Company in exchange for shares. The important issue is to ensure that the exchange is for the true value of the portfolio and any other assets it might transfer if the market value is not apparent. All relevant supervisory and regulatory authorities, including the NGO Directorate, the Companies’ Registrar, and CBI, must coordinate together to create a clear path for transformation. Allowing existing Iraqi microfinance providers (NGO MFIs) to take advantage of the NBFIs category of companies would create a level playing field among credit providers, and assist these entities to develop and grow. In general, in regulating and supervising NBFIs, the focus should be on rules to protect consumers and enforce transparency, and on reporting requirements.

3. Adopt financial consumer protection rules and have them apply to *all* financial services providers. Such rules should include basic measures regarding disclosure (e.g. simple format for terms of loan, standard format for pricing of products, ability to compare across products, information about FX risk for clients), transparency and reporting, fairness, and recourse. The NGO Directorate’s attempt to apply a supra-legal usury requirement should be discouraged given the lack of success that usury rates typically have in reducing excessive interest rates and the negative impact that such rates often have on outreach to the poor.

4. Establish a comprehensive credit information sharing system, which is typically very helpful in bringing down the costs associated with lending. A well-run and accurate credit bureau (housed in the CBI) can provide financial institutions with an inexpensive means of assessing the creditworthiness of many potential new borrowers. This can reduce associated risks for both MSMEs and lenders and thus reduce the risk of over-indebtedness⁴² and loan delinquency. By applying a zero threshold in the current credit information system at CBI and permitting NGO MFIs to participate (which presumably would be possible), the system will be useful for all financial institutions and not only banks. The participation of all financial institutions, including NGO MFIs, in the sharing system will also reduce the credit information gap.⁴³ In the interim, it

⁴² To avoid client over-indebtedness through multiple loans, some jurisdictions require obtaining a client’s credit report prior to granting a loan.

⁴³ Article (51) of the Banking Law gives the CBI the authority to include any entity in the Credit Information System.

would be useful to have a better developed information sharing system among the MFIs managed by the Iraq Microfinance Network or an IT company. In addition to an improved public credit registry, credit information could be further enhanced through the establishment of private credit bureaus. These often provide additional value-added services like credit scores that help banks to better assess the creditworthiness of individuals and firms and ultimately enhance their access to financing.

5. Encourage bank downscaling. The banking regulations should clearly permit banks to use agents and should set forth who can act as agents (e.g. individuals, legal entities) and what activities agents may engage in (e.g. AML/CFT compliance, deposits and withdrawals). The regulations should also specify the provisioning for microloans (which should be the same for all microloans, regardless of what type of institutions is providing them). Finally, the regulations should have appropriate risk-weighting of microloans.

6. Shift the role of the government from direct funding provider to facilitator or wholesale funder. Direct government funding schemes that make below-market or interest-free loans – such as the interest-free loans made pursuant to the Support of Small Income-Generating Projects Law – have low repayment rates and are inefficient in solving the finance gaps in the society. Moreover, such government interventions create market distortion due to the unfair competition with the private sector. Historical evidence has shown that governmental subsidized lending programs were usually associated with high default levels, absorbing large amounts of public funds and harmed the development of sustainable lenders without achieving the desired results.⁴⁴ A better alternative would be for the government to act as a facilitator or to provide wholesale funding to banks and other financial institutions that are more capable of managing loan portfolios and of reaching the targeted segments of the population.

7. Permit MFIs to be agents of insurance companies (with appropriate safeguards).

8. Establish a fast-track process for loan recovery. Comprehensive court reform, to increase the capacity of courts to dispose of cases in a timely manner, may not be achievable in the short or medium term. However, greater use should be made of computerized case management and the capacity of the execution department within the court system should be increased. More broadly, summary procedures should be introduced in cases of simple contract enforcement/debt collection, either alone or as part of a specialized commercial court system.

9. Adopt the appropriate legal framework for leasing and secured transactions, as the existing one is not conducive to the development of this form of finance. Financial leasing and the use of various movables as collateral can greatly increase private sector access to credit in Iraq and reduce its cost. An appropriate legal framework would allow these new mechanisms to expand and would make sure there is a level playing field for all financial institutions especially in regards to tax treatment; therefore, reform should include both the enactment of laws on financial leasing and on secured transactions as well as the development of a movable collateral registry to publicize lenders' security interests in movable assets and to establish their priority in these assets.

⁴⁴ For more information, see the CGAP Donor Brief "[The Role of Governments in Microfinance](#)" (2004).