

# Building Resilience Through Digital Financial Services

Africa COVID-19  
Digital Finance Market Impact Series

Iraq

The **COVID-19 pandemic** highlighted the important role **digital financial services (DFS)** can play in reducing disruptions to supply chains, maintaining economic activity, supporting social transfers and ensuring safe transactions while maintaining social distancing.

In these challenging times, IFC's DFS advisory worked with clients to build resilience and capacity through the Covid-19 crisis while designing, building and developing innovative business models for financial inclusion. This DFS market research series endeavours to share the insights gathered through this work.

**Iraq** is one of the most oil-dependent countries in the world, and while the oil markets have recently rebounded from the impact of political instability and the Covid-19 pandemic, the future remains volatile without investment in a more diverse economy. **As the primary employers in Iraq, small and medium enterprises (SMEs) are key to non-oil economic growth and innovation, but they operate in a challenging environment.**



**99%** of exports are from oil revenue

**85%**

percent of the government's budget, and

**42%**

percent of gross domestic product (GDP).<sup>1</sup>

**With a strong cash culture, high interest rates and a general distrust in banks, SMEs lack reliable access to finance, creating a barrier to sustainable and inclusive economic growth.**

The unmet demand for credit, and other financial services, highlight a significant opportunity for public and private financial institutions. Furthermore, Iraq has about 45.7 percent active mobile phone connections, which suggests that DFS may be part of the solution to increasing financial inclusion. However to achieve financial inclusion, banks would need to change their perception (SMEs are perceived as higher risks), reduce transactions costs, and create innovative products targeting the SME market. The government, meanwhile, would need to address stringent regulations restricting banks' lending in the country.

## IRAQ: KEY COUNTRY STATISTICS



**43-53 million**

Population



**\$207**

billion USD



**45.7 million**

or 101.7% of the population has active mobile phone connections



**74**

Financial institutions

Sources: WBG 2021

Sources:

<sup>1</sup> IFC Market Bite Iraq: Economic Recovery Creates Opportunity to Invest in Small and Medium Businesses

## IMPACT OF THE COVID-19 PANDEMIC

Iraq's economy is gradually recovering from the impact of the COVID-19 pandemic, which was particularly harsh as it coincided with a sharp decline in oil prices. Oil GDP shrank by 17 percent in 2020, while the non-oil economy contracted by 9 percent. Revenue from religious tourism diminished, and the services and hospitality sectors were hard hit by successive lockdowns and restrictions.<sup>2</sup>

Oil price volatility and the pandemic placed severe strain on Iraq's economy, leading to a precarious fiscal position and threats to peoples' livelihoods. As economic growth rebounds on the back of rising oil prices, there is an opportunity to invest in a diversified private-sector-led economy driven by the country's small-scale entrepreneurs to support broad-based development.

### Measures by banks to mitigate effects of Covid-19

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| <ul style="list-style-type: none"> <li>Central Bank deferred "One Trillion Dinar" loan payments, from the months of March to August, to the end of 2020.</li> <li>Banks' interest rates were reduced from 4 percent to 2.7 percent.</li> </ul> | <ul style="list-style-type: none"> <li>Borrowers who had taken loans as part the "One Trillion Dinar" facility could to take an interest-free loan of US\$ 4,20065.</li> </ul> |
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## DFS MARKET OVERVIEW

Though they play a central role in the economy, SMEs are not well integrated into the formal financial sector. Overall, credit markets are severely limited and SME credit is the smallest sub-sector compared to retail (or personal) and corporate credit. Aside from the size of the credit market, the financial sector in Iraq is weak as evidenced by relatively high non-performing loan (NPL) ratios and hefty operational costs.<sup>3</sup>

Although there has been some support for the SME market, most notably the One Billion Dinar Initiative launched by the Central Bank of Iraq in 2015, education and training are lacking around these initiatives and many challenges remain.

### Iraq Financial Structure Overview



Overall number of financial organizations in the country to 74.



- State owned banks (SOBs) own 78.6% of the banking sector's assets.
- Control 84% of cash credit extended.
- Have 87% of the total deposits.
- Have extensive branch network throughout the country.
- Constitute 45.5% of total bank branches in the country.
- They are government-guaranteed.
- Constitute only 9% of the total number of banks in the country.



- Account for 90.5% (67 out of 74 banks) of the total number of banks.
- PSOBs make up the vast majority of the banking sector's capital.
- Accounting for 75.4%, owing to their greater number.
- Adherence to the central bank's directive of having a minimum capital of 250 billion IQD.
- Heavily overshadowed by SOBs, accounting for only 13% of total deposits, 16% of extended cash credit, and 21.4% of the banking sector's assets.



- Prepaid cards, in particular, have grown exponentially in popularity, with over 9.7 million cards issued by the end of 2021.
- This preference is due to the ease of their use and the simplicity with which they can be obtained without the requirement to create a bank account.

Source: TBC

Sources:

<sup>2</sup> IFC Market Bite Iraq: Economic Recovery Creates Opportunity to Invest in Small and Medium Businesses

<sup>3</sup> IFC SME Finance Assessment – Iraq (draft report 2021)

<b>Support for the SME market</b>	
<b>2004-2015</b>	<ul style="list-style-type: none"> <li>• USAID in collaboration with private Iraqi banks sought to expand access to credit for SMEs resulting in:</li> <li>• The Iraqi Company for Bank Guarantees (ICBG) and the Iraqi Company for Financing SMEs offered loans in the range of \$5,000 to \$250,000.</li> <li>• Iraq Middle Market Development Foundation (IMMDF) financed upper-medium sized companies with a total portfolio of around \$80 million.</li> <li>• GroFin offers finance to lower-medium size enterprises offers an average loan size of \$600,000 and has a portfolio of about \$6 million.</li> <li>• Under the umbrella of the Iraq Governance and Performance and Accountability program (IGPA), some training has been provided to commercial banks on SME financing</li> <li>• The Ministry of Labor and Social Affairs provides mentorship and incubation support directly to SMEs, while some NGOs, the Chamber of Commerce, as well as vocational training centers provide training in various aspects of business support.</li> </ul>
<b>2007-2012</b>	<ul style="list-style-type: none"> <li>• IOM and Ministry of Labor provided microloans as livelihood support in response to the humanitarian crisis in Iraq due to the ISIS insurgency MoLSA has been providing microloans to the unemployed since 2007 where a fund solely dedicated to SME loans (as described by MoLSA) was formed in 2012.</li> </ul>
<b>2015</b>	<ul style="list-style-type: none"> <li>• The One Trillion Dinar Initiative was launched by the CBI in 2015 to support the SME sector. With more than \$540 million of the earmarked \$840 million extended in subsidized loans through commercial banks, the uptake has accelerated significantly since 2020.</li> <li>• It now also covers housing loans, a category that has overtaken SME loans.</li> </ul>

## GAPS AND RECOMMENDATIONS

<b>REGULATORY</b>	<b>DEMAND SIDE</b>	<b>SUPPLY SIDE</b>
<ul style="list-style-type: none"> <li>• Informational asymmetry due to the absence of an SME credit bureau which is in turn difficult to establish due to high informality among SMEs.</li> <li>• Undervaluation of real estate collateral and lack of legal stipulations to encourage the collateralization of movable assets.</li> <li>• Tedious and difficult bureaucratic procedures in the case of default.</li> </ul>	<ul style="list-style-type: none"> <li>• SMEs are treated the same as corporates. They are not given tax benefits but pay the same corporate tax rate of 15 percent as larger corporations.</li> <li>• Absence of regular accounting by SMEs.</li> <li>• Poor management due to the family-ownership of most SMEs .</li> <li>• There is no shared, or commonly accepted definition of SMEs in Iraq, which means different actors use different parameters to define SMEs in terms of number of employees, turnover and loan size, for example.</li> <li>• Reliance on cash and informal lending.</li> </ul>	<ul style="list-style-type: none"> <li>• SME lending in Iraq is guarantee-based rather than cash-flow based, with financial institutions (FIs) heavily reliant on traditional guarantees such as real estate collateral and guarantor (kafeel) salaries of mostly public sector employees.</li> <li>• Iraq does not currently have a fully developed credit information infrastructure, nor does it have a comprehensive security interest framework.</li> <li>• Undervaluation of real estate collateral and lack of legal stipulations to encourage the collateralization of movable assets.</li> <li>• FIs' officers lack of skills, particularly in financial analysis.</li> <li>• Commercial banks overlapping with MFIs in providing lower bracket loans.</li> </ul>

## OPPORTUNITIES FOR MARKET GROWTH

To address the challenges and increase SMEs' access to finance, the following is suggested:

### Regulation:

- The secured transactions law could be reformed to promote the use of movable assets as collateral, and to simplify the liquidation and foreclosure process in cases of default. The reform should also be complemented with the establishment of a collateral registry to reduce informational asymmetries.
- MFIs lending activities should fall under CBI.
- Legal measures should be introduced to facilitate the partnership of MFIs and commercial banks.

### Financial Institutions:

- FIs need to rethink their selection process to focus on SMEs with growth potential by following a supply-chain approach in the screening phase.
- In terms of underwriting, FIs need the guidance of a third-party to offer guidance to their loan officers on cash-flow analysis and loan origination with movable assets as collateral.
- FIs should focus on building internal capacities to enable them to increase their SME segment portfolio.

### Digital Financial Services

Promote the digitization of SMEs transactions. With the absence of an SME credit bureau, FIs find it costly to assess the creditworthiness of SMEs. There are other alternatives to traditional credit bureaus such as cash-flow credit scores, which are only feasible when SMEs digitize their transactions. Besides from being a necessary prerequisite for cash-flow credit scores, digitization of SMEs transactions is a prerequisite for more advanced activities such as platform-based lending and digital cash advances.

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Authors: TBC

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