Working Paper

IRAQ
United Nations/World Bank
Joint Needs Assessment

Financial Sector

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I. INTRODUCTION

1. This note provides a first assessment of needs in the financial sector in Iraq. The assessment follows a July 2003 visit to Baghdad (Samir El Daher, Regional Financial Sector Advisor, Middle East & North Africa; and Robert Liu, Advisor, Financial Sector Operations and Policy Department), conducted in parallel with an IMF mission focusing on the financial system. Meetings were held with the Coalition Provisional Authority (CPA) as well as with Iraqi officials at the Central Bank, and at the two main commercial banks – Rafidain and Rasheed. A number of conclusions presented in this report are therefore based on desk reviews of relevant data.

2. Banking is the main component of the Iraqi financial system. Capital markets, besides government debt instruments, are largely nonexistent. State-owned insurance companies are inactive. The stock exchange was tiny and is now closed. (In 1991 the government of Iraq adopted legislation to create the Baghdad Stock Exchange without setting a date to start operations. The Exchange was intended as a place to trade government securities, channel local private sector funds into investment projects, and purchase shares in companies to be privatized. The failure of government bond issues to attract significant private investment and the suspension of the privatization program in Iraq's post-sanctions economy dampened the prospects of a stock exchange take-off.)

3. The banking system is presently hardly functional with no credit facilities and no effective payments system, although an increasing number of branches are resuming operations, particularly in the Iraqi north. The situation is further complicated by the fact that only two Iraqi banknotes are now in circulation: the ID10,000 denomination bill and the ID250 denomination bill. The ID10,000 bill has been largely counterfeit as top members of the former regime had reportedly access to Central Bank printing facilities. There is therefore no public acceptance for the large bill as mode of payment except at some 30 percent discount. The one main legal tender has become de facto the ID250 (equivalent to 17 US cents), too small a denomination to support a normal economy. Moreover, printing capacity at the Central Bank makes it hard for the latter to keep up with demand on such a scale. This situation presents a considerable impediment to day-to-day business transactions and economic activity. It is now anticipated that new bills in small and large denominations would be introduced on October 15, 2003. Developing an effective payments system inter-alia for implementing the currency exchange scheme – for which preparations are underway – is a pressing concern. The role of the two main commercial banks, Rafidain and Rasheed, is expected to be critical to the success of the currency exchange which would be managed by the Central Bank.

4. The process of reinvigorating the financial sector in Iraq is contingent upon resumption of banking operations. To this end, the immediate need would be to re-establish a normally operating branch system to sustain a reliable payment process in the country, and a functional Central Bank able to resume its critical functions as provider of liquidity and lender of last resort to the banking sector. The IMF is engaged with the Iraqi Central Bank in a number of areas including advice on the revision of the Central Bank law and the commercial banking law as well as on the process for the planned currency exchange.

II. CURRENT STATUS OF IRAQ'S BANKING SECTOR

A. Institutions: size and ownership structure

5. The Iraqi banking system consists, in addition to the Central Bank, of twenty-two chartered banking institutions: two public and sixteen private sector commercial banks; and four specialized public banks. In aggregate, the banking system has some US$2 billion equivalent in assets – of which over 90 percent are state-owned – accounting for a meager 8 percent of Iraq's estimated GDP. This poor ratio underscores the marginal role played by the banking sector both as a provider of resources to the economy and as a store for national savings. The system has a total network of 550 branches, of which 450 are for public sector banks. The list of Iraqi chartered banks is provided in Annex 1.

(a) State-owned commercial banks

6. Iraq nationalized its commercial banks in 1964. In 1974, four commercial banks were merged into one – Rafidain -- which had a commercial banking monopoly until Rasheed bank was established by the government. Before the Gulf War, Rafidain was the Arab world's largest commercial bank with total assets of US$47 billion. It also conducted transactions for the government of Iraq which usually are part of Central Bank's activities. The commercial banking system is now dominated by Rafidain and Rasheed, two public sector banks which, combined, account for over 90 percent of commercial banking assets (52 percent for Rafidain and 38 percent for Rasheed) and over 75 percent of the commercial bank branch network. Rafidain has total assets of ID1.55 trillion (US$1.03 billion equivalent, bearing in mind the collapse of the national currency) and ID19 billion in equity capital (US$12.7 million equivalent). Rafidain also holds, on an off-balance sheet basis, relatively sizeable foreign currency amounts in a custodian account on behalf of the Government of Iraq. Rafidain has 250 branches of which 71 are in Baghdad and nine overseas (including Amman, Bahrain, Beirut, Cairo, London and Sanaá). Rasheed has total assets of ID1.12 trillion (US$750 million equivalent) with ID12.6 billion in equity capital (US$8.4 million equivalent). Rasheed has 140 branches of which 52 are in Baghdad; it has no foreign branch network. The two main banks appear grossly undercapitalized although on a risk-adjusted basis, the ratio of capital to risk bearing assets is less worrisome as the bulk of the banks' exposure is limited to government risk given the dominant holding of Iraqi government Treasury bills in the portfolio. As far as staffing is concerned, Rafidain has a total of 8,900 employees – an excessive number by any productivity measure – and Rasheed about 4,500 employees.

(b) Private sector commercial banks

7. Private banks are small, with average assets of ID17 billion (US$11 million) and average capital of ID1.2 billion (US$800,000 equivalent). The first to be granted a license was Baghdad Bank in 199; the first three to be established (in 1993) were Baghdad Bank, the Iraqi Islamic Bank for Investment and Development, and the Commercial Bank of Iraq. The total assets of private banks ranges from ID4 billion (US$2.7 million equivalent) for the smallest (Warka Bank), to ID52 billion (US$35 million equivalent) for the largest (Middle East Investment Bank). Equity capital ranges from ID0.4 billion (US$270,000 equivalent) to ID2.7 billion (US$1.8 million). In aggregate, their assets are estimated at ID278 billion (US$185 million equivalent) and equity capital at ID19.5 billion (US$13 million equivalent). Private banks have a network of over one hundred branches in total.

(c) State-owned specialized banks

8. Iraq has four small state-owned specialized banks: the Agriculture Cooperative Bank, the Industrial Bank of Iraq, the Real Estate Bank of Iraq, and the Ishtiraqi (Socialist) Bank. Detailed financial statements for the four banks are yet to be made available to the World Bank. Preliminary data however show that the combined assets of the four banks amount to ID159 billion (US$106 million equivalent). The Agricultural Cooperative Bank is the largest with total assets of ID79.2 (US$52.8 million equivalent), followed by the Industrial Bank with ID52 billion (US$34.7 million equivalent), the Real Estate Bank with ID14.9 billion (US$10 million equivalent) and the Socialist Bank with ID12.6 billion (US$8.4 million equivalent). The Industrial Bank has the largest equity position with ID4.9 billion (US$3.3 million equivalent), followed by the Agricultural Bank and the Real Estate Bank, each with ID1.1 billion (US$730,000 equivalent) and the Socialist Bank with ID1.0 billion (US$670,000 equivalent). The four banks have 69 branches in total, with the Agriculture Cooperative Bank having the largest network with 42 branches, followed by the Real Estate Bank with 18 branches, the Industrial Bank with five branches and the Socialist Bank with four branches. In terms of staffing, the four banks have 2,015 employees in aggregate – a relatively excessive number distributed as follows: 885 employees at the Agricultural Bank; 710 at the Real Estate Bank; 186 at the Industrial Bank; and 234 at the Socialist Bank.

B. Asset structure of Iraqi banks

(a) State-owned commercial banks

9. A preliminary assessment of the financial structure of Rafidain and Rasheed, reveals the unusual fact that Iraqi state-owned commercial banks have hardly extended credit to the corporate sector, be it public or private. State-owned enterprises rather get budgetary funding in the form of grants and hidden subsidies; in the process the government acts as intermediary between banks and state-owned enterprises. Indeed, Rafidain bank's loan portfolio accounts for about 8 percent of total assets (58 percent of which is for state-owned enterprises). Under the price controls and subsidy schemes that prevailed, state-owned enterprises have been funded through government budget. The government in turn would finance itself by issuing debt in the form of Treasury Bills (TBs) subscribed by the banking sector – mostly Rafidain and Rasheed. As a result, TBs account for about two-thirds of Rafidain's assets and fifty percent of Rasheed's. At the same time, state-owned enterprises had to place their deposits with state-owned commercial banks; these deposits represent about half of Rafidain's total deposits. Given limited financing extended by banks to the state-owned enterprise sector, the latter appears to be, in aggregate, a net creditor of the state-owned banks.

(b) Private sector commercial banks

10. With less than a tenth of the asset base of the banking sector, the loan portfolios (ID110 billion, or US$74 million equivalent) of the 16 private banks represent in aggregate over one third of all commercial banking loans to the corporate and household sectors – i.e. more than half (52 percent) of the combined loan portfolios of Rafidain and Rasheed. Some of the private banks however are part of larger domestic groups with diversified business interests which makes it not unlikely that part of the loans may be for connected parties. This makes it necessary to carry out a thorough review of the bank loan portfolios and, going forward, to ensure proper regulation regarding, inter-alia, issues of connection lending.

(c) State-owned specialized banks

11. Detailed balance sheets for the specialized banks, which would allow a close analysis of bank portfolios, were not made available to the World Bank. The one detailed balance sheet available (for the Industrial Bank) shows that 70 percent of the bank's assets are in cash or government securities while 15 percent are classified as "Saddam loans" made on presidential orders at low interest rates to selected borrowers. The asset structure of the three other specialized banks is likely to exhibit a pattern similar to that of the Industrial Bank, with a dearth of loans to the corporate and household sectors. All four banks posted profit for each of the two years ending 2001 and 2002 (2001 only in the case of the Real Estate Bank) with the following reported figures for the latest fiscal year: Socialist Bank – ID86.6 million (US$58,000 equivalent); Real Estate Bank – ID241 million (US$161,000 equivalent); Agricultural Bank – ID1.1 billion (US$732,000 equivalent); and Industrial Bank – ID4.8 billion (US$3.2 million equivalent), i.e. a 98 percent return on equity (which would cast some doubt on the reliability of the accounts).

C. Current Status of Banking Regulation and Supervision

12. The supervision of banks in Iraq is performed by the Banking Control and Auditing Department (BCAD) of the Central Bank of Iraq. This department was created in 1994 following the establishment of private banks in 1993. All banks whether private or state-owned are subject to regular supervision by the BCAD.

(a) Organization of the Banking Control and Auditing Department

13. The BCAD has five divisions – Inspection Division for on-site examination work, Audit Division for off-site monitoring, Research and Study Division for research related issues, Risk Division for collecting credit information on loans, and Administration Division for general administrative work. The BCAD has about 70 staff based in Baghdad. In addition, there are two other supervision offices in Basra and Mosul with 10 staff each. Although the Basra and Mosul offices have reporting lines to Baghdad, in practice, there is little coordination and minimal reporting between main office and sub-offices. The Basra and Mosul offices are used mainly for examination of financial institutions which are located in those regions. There is a major deficiency in the operations of these two sub-offices, including a lack of examination planning and coordination with the Baghdad office with the result that the two sub-offices operate more like independent entities. Furthermore, the results of the examination are not regularly communicated to the Baghdad office and reporting is done only on a "need" basis.

(b) Status of banking supervision

14. Overall, the banking supervision regime is poor and in need of significant improvement in all areas including banking and supervision laws, organization, technology, human resources and training, development of procedure and operational manuals, regulations, and supervisory framework. It is a multi-year task that requires significant resources and close partnership arrangements between various stakeholders, especially advisors and supervisory authority. One of the main reasons for the sub-standard supervision quality is the lack of skills. A main feature of the Iraqi banking system is that branches operate on a unitary basis, i.e. as "independent" entities with accounts reported to headquarters only on a periodic basis. There is no inter-branch banking as each customer has to visit his/her branch for withdrawals and deposits. Because of this unique feature, it is important for bank supervisors to make periodic examination of these branches in order to get a

true picture of the financial condition of the bank. However, the examination division has less than 30 staff, including Basra and Mosul, which makes it difficult to conduct a proper safety and soundness examination of all branches and head office of the banks every year. The banking supervisory system, although deficient in many respects, was sufficient under the previous regime because most banking activities were controlled and directed by the government. Bank management, whether private or public, operated with the understanding that there would be severe retribution if malpractices and other fraudulent activities were to occur (exception made for those practices committed with the tacit understanding of the authority). However with the change in regime, this "fear" factor no longer exists. Without significant improvement in the supervisory process, it would be difficult to control the activities of private banks and there is a potential for major financial crises.

(c) Legal framework for banking supervision

15. A legal framework exists for banking supervision though it needs significant improvement. The banking supervision department is aware of the weaknesses of the current regulatory and supervisory infrastructure. The senior management of the Central Bank is eager to improve the supervisory process and has in fact identified it as one of their top priorities. As a starting point, the Central Bank has requested the International Monetary Fund to help with the revision of the Central Bank and commercial banking laws. A Basle Core Principle (BCP) assessment that was performed recently by two international experts noted that "Banking laws are in place and the supervision of the public and private banks is defined in the 1991 Amendment No. 12 (Amendment), Part IV of the Law on Central Bank (the Law) and the formation of private banks is defined in Law No. 21 1997. The objectives stated in the Law are not clearly defined, but authority to regulate and supervise is in the Amendment. The Law needs clear objectives and a better-defined purpose for banking supervision. Safe banking practices that protect depositors and sound bank management are not noted in the Law. In many cases the legal framework is set, as in the loans-to-one borrower clause, but in practice, these laws were ignored by the banks and not enforced by the banking authority". Furthermore, in the revision of the banking law, powers would be provided to the banking authority to close, liquidate or restructure banks that are not operating in a safe and sound manner and/or do not comply with prudential norms. Although the supervisors had regular contact with bank management, access to information has been limited and sometimes restricted (in the case of banks well connected to the authorities). Supervisors had no powers to close, liquidate or restructure an institution. The only enforcement mechanism for supervisors was to impose money penalties; even in such cases the decision as to whether or not to impose money penalties was the responsibility of the legal department of the Central Bank and not the banking supervision department.

(d) Inadequate organization structure and limited use of technology

16. The organization of the supervision department is deficient in many respects. Despite the limited number of functions, some critical functions such as the data base division, accounting division and methodology division are missing from the organizational chart. The Auditing division, with a limited number of staff (12) is focusing on too many areas with a negative impact on work quality; it is responsible for collecting information from each bank, although its primary mandate is to conduct off-site monitoring. Some of the functions are also performed in a limited way. An example of this limitation is the financial analysis conducted by the Auditing Department which uses only six sets of financial ratios to analyze financial statements of banks (compared to more than sixty ratios that are used in more developed countries). The poor quality of financial analysis could be due to a lack of proper data, of human resources to do the work, of full understanding of the importance

of using financial ratios to analyze the financial condition of banks, of proper tools to calculate these ratios or a combination thereof.

17. The use of modern technology for supervision, especially computers is very limited. Most of the work, including the retention of records is done manually. Some of the banks send their financial information to the supervisory department via diskettes which poses a real problem since not all banks have this capability. The introduction and more wide spread use of technology in the supervision department would have to be coordinated with the private sector in order to maximize its benefits.

(e) Status of Inspection Division

18. On the inspection process, the BCP assessment concluded that the "Supervisory process is more of a checklist process than a qualitative one. Safety and soundness is not a stated objective of the inspections, rather, the overriding objective is checking for compliance with existing laws". It also stated that in most cases, the inspection work focused on collecting data on compliance with five prudential regulations; namely, capital adequacy ratio, loan/ deposit ratio, deposit/capital ratio, fixed assets/capital and reserves and proper allocation of profit to reserves for bad debt, and collecting information on a list of overdrafts of customers and directors, past due loans, loans to directors and lists of insufficient funds checks. In the credit area, rather than evaluating the credit worthiness of borrowers, the inspectors focused on ensuring that legal agreements existed for all loans, an activity which is normally performed by the banks' internal auditors. While the collection of data is an integral part of the supervisory process, in most jurisdictions, the collection of this type of information is not the responsibility of the inspection staff but of another unit within the supervisory department. In the case of the BCAD, however, because the department is not properly organized to include all necessary functions, the responsibility for collection of these vital data is assigned to the inspection division with the result that the "normal" inspection work with respect to analyzing the safety and soundness of the regulated institution is not given proper attention.

(f) Dearth of skills and lack of operational and procedure manuals

19. The supervision department requires staff who understand the banking business. Recruitment procedures are poor with no clear guidelines as to the qualifications and experience the candidate should possess. There has been little recruitment from outside the Central Bank. Staff members have been transferred from other departments of the Central Bank sometimes with no regard to the specific needs of the Supervision Department. The level of training that is provided to staff is poor with no proper training manuals. Exposure to financial sector work in other parts of the world (e.g. Basle Accords, etc...) has been limited and restricted to research conducted in-house. While other Arab countries have made some training available, training programs have been limited in scope and frequency. There seem to be no procedural manuals for conducting on-site inspection and/or off-site monitoring. Many of the documents that were requested for verification were said to have been destroyed during the war.

III. PRIORITIES AND NEEDS IN THE FINANCIAL SECTOR

20. With a dysfunctional financial system featuring a poorly organized regulatory framework and ineffective institutions, the task of rebuilding a sound and safe modern financial sector in Iraq is daunting. It should start with the banking sector which is currently the essential component of the financial system and should cover the sector's legal and regulatory aspects as well as its main institutions. This would be a long-term process that will require significant resources, technical as well as financial.

21. In the immediate term, the work of rebuilding the banking system should focus on: (i) the resumption of banking operations for the two main commercial banks, Rafidain and Rasheed to allow the provision of essential financial services; (ii) the preparation and enactment of a new Central Bank law and commercial bank law; and (iii) the creation of an effective operating structure for banking supervision. Work would have to be initiated regarding the program of capacity building, institutional restructuring and reform that would need to be implemented over the medium-term.

22. Over the medium-term thus, there would be a need: (i) to develop and deliver the major training programs aimed at building and upgrading banking skills which are in dire shortage in Iraq; (ii) to draw and implement, within a medium to long term timeframe, the plans aimed at upgrading and modernizing the country's non-cash payment system including clearing and settlement and, in the ensuing period, developing electronic settlement facilities; (iii) to review the accounting and auditing framework in the financial industry, and business sector as a whole, to ensure congruence with internationally applicable standards; and (iv) for the authorities to address the status of the specialized state-owned banks as well as to encourage the process of consolidation within the small and fragmented private commercial banking system. Once work on this agenda has been started, the authorities should address the institutional building needs in the non-bank segment of the financial industry, namely the insurance and capital markets; the focus would be both on the legal and regulatory framework of the markets as well as on the institutional strengthening and restructuring of the insurance companies and the Baghdad Stock Exchange.

A. Resumption of main banking services and related bank restructuring issues

(a) Resumption of banking operations of Rafidain and Rasheed

23. (i) - Relevance of Rafidain and Rasheed in the Iraqi finance sector. Rafidain and Rasheed respectively have over 700,000 and 1 million accounts, and encompass over 85 percent of Iraq's banking system assets. The CPA recognizes – and the World Bank team concurs with this assessment – the potentially important role that Rafidain, and to a lesser extent, Rasheed, could play in the provision of financial services in Iraq. Rafidain, in particular, which had been for decades the flagship of the Iraqi financial system, retains in its name a goodwill and a franchise value despite the sorry institutional state to which it was brought under the previous system. Keeping Rasheed in operation, despite reportedly a lesser quality of professional skills compared to Rafidain, would not leave the latter in a monopoly position at least in the short-term.

24. (ii) - Provision of essential banking services. Resumption of banking operations by the two banks will be essential to reestablish a normal payment system, facilitate the proposed currency conversion, transfer salaries to state employees and allow initially limited financial services on bank accounts. This can be done by pursuing the reopening of the branches of the two banks wherever

security permits and the safety of bank employees, clients and assets can be ensured. Bringing back branches into full operation would boost public confidence in the banking sector and smooth the system of payments. Although it is reported that most of the bank financial records are largely intact as they had been removed from banks' premises prior to the looting, the challenge would be to verify the authenticity of these records. While the authentication process is taking place, the authorities, based on specific checks and reviews, may want to allow limited withdrawals from those accounts that may still be frozen so as to ease the financial burden on those economic agents that may have financial assets tied up in the two banks. A good communication strategy should also be developed to inform the public on various banking issues that could affect their interests. Information would cover activities related to the two large banks, and also those of the specialized state-owned banks and private commercial banks. Disseminating valuable, reliable and timely information to depositors and borrowers may help dispel unwanted rumors and strengthen the confidence in, and the transparency of, the banking system.

25. (iii) - Need for regulatory framework conducive to bank credit extension. Lending is a main function of banking institutions. However, the unique circumstances now prevailing in Iraq make it more important in the near term to focus on payment and depository services to the household and corporate sectors. Once these services are provided, lending would become the next area of bank focus. In this context it should be recognized that engaging safely, let alone successfully, in bank lending is predicated upon the existence of, inter-alia, bankable demand for loans and credible borrowers able to furnish reliable financial statements, and the possibility for banks to conduct loan monitoring and collection in an effective way. Without such critical elements of a credit culture, banks that precipitously engage in credit extension are likely – without adequate guarantee mechanisms – to be saddled with high levels of non performing loans that may sow the seeds of future financial crises. In the meantime, to respond to the pressing funding needs of the corporate sector, and especially private firms, enterprise financing may need to be extended by-and-large (except possibly for some of the leading business groups) under specific risk-capital funding schemes that would need to be designed but in which the banking sector at this stage may not be involved as a principal party.

26. (iv) - Resolution of issues of legal claims on Rafidain's assets. Rafidain has been subject to lawsuits where plaintiffs were seeking remedies against the previous government of Iraq in impounding assets from the foreign branch network of Rafidain – legally viewed by plaintiffs as "alter-ego" of the Iraqi sovereign entity. It is important that a solution be found to this issue so that Rafidain may conduct its financial activities unhindered by such potentially crippling legal risk. One such solution (to be assessed) would be for the sovereign entity to assume the legal claims. In fact, per Rafidain's financial statements, the foreign currency "holdings" – US$759 million; 60 million Euros; and 10 million Jordanian Dinars – are not part of the bank's balance sheet, but held in custody by Rafidain on behalf of the Government of Iraq. Should this be the case, the foreign liabilities of Rafidain ought to be treated as claims on the Iraqi sovereign authority.

(b) Management for Rafidain and Rasheed

27. The CPA is proposing to have the two banks operate under a management contract, for which requests for expression of interest by reputable foreign banks have been issued. Given the unsettled management structure of both banks, a contracted management scheme might be a worthwhile option to consider in order to put quickly on rails the banks institutional and restructuring agenda. To be successful, however a management contract – distinctly different from an advisory assignment – must bestow full executive powers and operational authority to the contracted firm. It would involve

a large number of highly expert staff and usually comes with a high price tag, especially if – as it ought to be – quality firms were involved. Moreover, in the case of Iraq, the potential mandate of the contracted firm would not be limited to improving operations and enhancing profitability, but would need to be far reaching in providing for full institutional (re)building of these banks and putting them eventually on the path to privatization.

28. In such a context, in addition to what relates to managing the banks, the terms of reference for the contracted firm should provide, first, for a diagnostic review of the operations of the two banks. Using the results of the diagnostic review, which would require approximately three months to complete, the management company should develop: (i) a business plan based on an analysis of "strengths, weaknesses, opportunities and threats" (the so-called "SWOT" approach); and (ii) an institutional strengthening program with a timetable for implementation. An additional month would be needed to develop the business plan and program of actions. The program of actions should be developed with input from all stakeholders, particularly Iraqi counterparts. As part of its mandate, the management team must train the local staff, who eventually would take over and provide the core management of the banks. While the diagnostic review is being carried out, the management firm would operate the banks and provide essential, albeit limited, financial services to the public.

29. Another option that would need to be considered and assessed – on its own merit as well as an alternative to contracting out management – is to build and strengthen Rafidain and Rasheed management with direct hire of high quality professionals with a proven record as executives and senior officers in the international banking industry. (Egypt has recently rejuvenated and modernized the management of its state-owned commercial banks in hiring Egyptian nationals who had a track record in senior managerial positions in foreign banks, with the mandate to improve the banks situation and prepare them for eventual privatization.) Considering this alternative is in any case advisable were the requests for proposals not to yield, on terms that are acceptable to the owners, the quality institutions and offers needed to transform Rafidain and Rasheed into sustainable and competitive banking institutions.

(c) Rehabilitation of bank premises

30. Banks are in need of physical rehabilitation. Indeed, in the aftermath of the war, most ministerial and administrative buildings were subject to looting and arson. The Central Bank and a significant number of commercial bank branches were attacked and destroyed. Reportedly 70 of Rafidain's 250 branches, and 85 of Rasheed's 140 branches were looted. On average, US$25,000 equivalent is the estimated cost of rehabilitating a branch – a total cost of about US$10 million equivalent for the two banks when including the costs of headquarters rehabilitation. Though small in absolute terms, this amount represents close to 50 percent of the combined equity base of Rafidain and Rasheed. All four specialized banks were also looted in the aftermath of the war with some ID2.3 billion (US$1.5 million equivalent) stolen from their vaults. The Industrial Bank was the most severely affected with all its 5 branches out of operation and most of its cash stolen (ID1.6 billion or US$1.1 million equivalent). Reopening of branches has been slower than expected, partly reflecting reluctance to reopen before security improves, although progress in this regards has been reported over the last month. None of the banks – except the industrial bank – considers the availability of cash to be an impediment to reopening as banks still have sufficient cash reserves. In the process of destruction, records were lost and those which were not retrieved by diligent managers to the safety of their own houses may be difficult to reconstitute as most records are in paper form with no electronic supporting data. Branches, in a way, operate as self contained business units with accounts

communicated only periodically to head office for consolidation. Reconciling and re-establishing depositors' claims and borrowers' obligations may loom ahead as an arduous task.

(d) CPA's proposal to cancel intra-government debt: Effect on banks

31. In addressing the issues pertaining to bank and enterprise restructuring, a proposal has been put forth within the CPA to write off all intra-government debt. The only claims that would be honored would be those that relate to private sector and foreign entities. The idea is that public entities' obligations vis-à-vis other public entities are more of an internal accounting issue than real economic liabilities. Moreover, debt cancellation would inter alia avoid litigations between various government agencies as many records have been reportedly destroyed or lost with no assurance that remaining records properly reflect net debtor/creditor positions. The main entities that would be affected by the debt write-off proposal are the two state-owned banks, Rafidain and Rasheed, SOEs which total about one hundred and ninety two, and government ministries and agencies. Were it to be implemented, the measure would result in the following: (i) loans granted by public banks to state-owned enterprises would not be repaid; (ii) state-owned enterprises would in turn forego their deposits in public banks; (iii) public banks which have large holdings of Treasury bills would forego their claims on government; and (iv) government would forgive whatever funding it had provided to state-owned enterprises, though the bulk of the funding was most likely provided on a grant basis.

32. The argument made in favor of the cancellation in what relates to banks is that it might improve the financial (and liquidity) position of the banks if these were to receive fresh capital in the context of the debt write-off, whereas there might be little assurance that the government would redeem the existing treasury bills and provide the needed liquidity to the banks. With assets no longer tied up in government treasury bills, banks could have the cash to make new loans and focus attention on new lending and institutional building. Moreover, when the current freeze on deposits is lifted, the strong SOEs might withdraw their deposits while weaker ones might not be able to pay back their bank loans – which might require in any case a capital injection given the banks' need to provision the non-performing SOE loan portfolio. A new, trimmed-down balance sheet might also facilitate the privatization of state-owned banks because their remaining assets would not be government treasury bills or loans to SOEs, but mainly, and hopefully, quality loans to the private sector.

33. While the debt write-off proposal would speed up the process of corporate restructuring, and net out the respective exposures between public sector parties in a budget neutral way, it would have different effects on different institutions depending on whether these are net debtors of, or creditors to, the system. The netting out process between state-owned enterprises and banks would penalize the enterprise sector which is a net creditor of the banks – although the survival of a state-owned enterprise would depend largely on whether it is considered strategically important for the country's economy (e.g. power company, in which case the resources needed for rehabilitation would dwarf the deposits that would be foregone).

34. Canceling public bank claims on government would affect in a major way the two state-owned banks which are large holders of Treasury Bills which account for two-thirds of Rafidain's assets and half of Rasheed's. The debt write-off would lead to the banks' insolvency, unless as part of the cancellation program, the two banks are recapitalized with enough new capital to meet minimum capital adequacy requirements and also fund assets growth. (For Rafidain for instance, such a measure would require a recapitalization of some ID200 billion – US$135 million equivalent – so that claims of Rafidain's private depositors could be honored.) Injecting funds back into the

banks in return for the write-off of their Treasury bills portfolios would have a neutral effect on the budget. Were the recapitalization to be in the form of debt securities issued by the government and held by the banks – a common feature of state-owned bank recapitalization – it would merely result in replacing an old portfolio of Treasury bills by a new one with no effect on bank liquidity.

35. Whatever the potential merits and pitfalls of a general intra-government debt write-off measure, it would be necessary, in the World Bank team's view, to assess at the outset the impact that such a blanket measure may have on a selected number of individual (large) enterprises in the corporate and the financial sector, and which are judged to be critical to the Iraqi economy; Rafidain and Rasheed are part of this category. Besides, any such decision might need further study in what relates for instance to the authority to cancel the debt, or the impact on SOEs (if any) which might have small private sector ownership interest.

B. Legal framework for the banking system

36. Work has begun in order to define the legal and regulatory framework needed to foster and spur the development of an open and competitive financial sector. Experts from the CPA had already initiated a process of reviewing Iraqi banking laws. At present, there is a dual legal system for banks, which do not put private and public sector banks on a level playing field. This discriminatory legal status would need to be rectified through the adoption of a uniform legal framework for banking. The CPA asked the IMF to redraft both a Central Bank law and a commercial bank law – on which the World Bank would have the opportunity to provide comments. While the draft Central Bank law is yet to be received from the IMF, a preliminary review of the draft commercial banking law shows that it is comprehensive, and in line with international standards in seeking to provide a legal framework conducive to an open, market-based and well regulated banking system for Iraq. It addresses the provisions for bank licensing and defines the rules on entry and exit (eliminating for instance existing requirements for majority Iraqi control of all bank assets). It also suggests guidelines related to capital adequacy and exposure limits to borrowers and as a share of equity. In this regard, a question may be raised as to whether such specific guidelines ought to be incorporated in the law or should rather be defined – and occasionally revised – in circulars that would be issued by the Central Bank as the regulatory authority. Final comments on the draft laws would be communicated to the IMF and the CPA once the documents have been reviewed by the World Bank Legal Department.

C. Banking supervision

37. The framework for and legislation on banking supervision would need to be addressed. In particular, and as part of the development and modernization of the country's financial sector, attention should be devoted to building a strong regulatory and supervisory system. This is important to ensure that the public has confidence in the financial system, markets are developed in an orderly manner, and banking activities are conducted with proper oversight from financial authorities. In this context, for private banks, a mechanism needs to be in place – and would be reflected in banking legislation – including a process of due diligence for the review of bank owners and partners and rules for closure when certain prudential standards cannot be met.

38. In terms of specific steps, the institutional development of the banking supervisory department should begin with the identification and appointment of an experienced and knowledgeable bank regulator. Stationed in Baghdad, this resident adviser will work closely with senior officials of the banking supervisory department. With the help of the resident adviser, the

banking supervision department should prepare an institutional development plan, identifying areas for improvement along with a defined time bound development action plan. As the action plan is implemented, further technical assistance would be required. In particular, the supervision department would need IT expertise to develop and operate a data base, while banking experts would be needed to develop a management information system. Similarly, assistance would be required to develop on-site and offsite examination manuals. The resident adviser would provide oversight on the implementation of the action plan and assist the supervision department in: (i) identifying the expertise and resources needed to complete each section of the action plan; and (ii) defining the programs of training needed to build the required skills.

D. Specialized state-owned bank restructuring

39. After addressing the three urgent issues – resumption of main banking services of Rafidain and Rasheed, revision of the Central and commercial bank laws, and strengthening the operation of the banking supervision department – attention can be turned to the issues confronting the operations of the four specialized state-owned banks and the private sector banks. In the meantime, where security permits, branches of the four specialized state-owned banks should be opened to serve the public and offer necessary albeit limited financial services. It would complement the work of the other two large state-owned banks.

40. When devising the strategy regarding the role of specialized state-owned banks, it should be recognized that some of these banks with a small balance sheet and tiny branch network might lack the minimum economic scale required to deal in a new market-based competitive environment. A decision would need to be taken as to the role and future of these banks, including an assessment as to whether the four specialized banks could be beneficially consolidated and merged into two medium size banks. For instance, it might be argued that the Socialist bank – the smallest of the four, with a mere US$8 million equivalent in total assets and only four branches – set up in 1991 "to provide interest free loans to soldiers having earned more than three medals during the 1980-88 Iran war" has lost its "raison d'être" and may be contributing little to economic activity. The Socialist bank might thus be merged with the Agriculture bank to form a rural financial institution with US$60 million equivalent in total assets and 46 branches, while the Industrial bank and the Real Estate bank could merge to form a long-term credit institution with US$45 million equivalent in total assets with a branch network of twenty-three units. Following the merger, these banks, if need be, could also be run for a period under a management contract. A plan of actions similar to the ones used for the state-owned commercial banks would also need to be implemented. When defining the business plans for the two specialized banks created out of the mergers, an assessment could be done as to whether some of the branches that would not be required by Rafidain and Rasheed might be absorbed by the specialized banks so as to expand eventually their geographic coverage and improve the channel for credit extension to underserved areas or sectors. Broadening the branch network of the state-owned specialized banks relative to those of Rafidain and Rasheed might also help contain the dominant market powers of the latter two and ease the potential process of privatization.

41. Plans have been prepared for the establishment of a new "Trade Bank" with a paid-in capital of US$5 million and callable capital of US$100 million backed by future receipts from oil exports. Invitations had been issued to leading international banks to form consortia for managing the Trade Bank. In the longer term, the role of the Trade Bank and its specialized business mandate within the financial sector should be assessed as with all domestic banks once the banking system is in full operation.

E. Private commercial bank consolidation

42. Existing private sector banks are too small and fragmented to offer effective competition to the state-owned banks. Furthermore, they lack the resources needed to upgrade their operating systems, infrastructure, and risk management tools. It might also be argued that given the current level of market development in Iraq, the existence of over twenty domestic banks would lead to unhealthy competition and poor bank profitability. Banks as a result would be unable to pay adequate salaries and provide training to staff, offer effective banking services, and expand the scope of business. Bank regulators could, in time, encourage these banks to consolidate and become more relevant players by imposing more stringent regulatory requirements including higher capital adequacy limits, and tightening risk management guidelines and corporate governance standards. In this process, adequate lead time should be given to the banks to assess the potential for alliances, given existing synergies, comparative advantages, complementarities, market positions, among other considerations. The medium-term goal would be to consolidate the 16 currently chartered, privately-owned banks into four to six medium size banks. The ultimate objective would be to have about eight to ten private sector banks operating in Iraq (assuming state-owned banks are privatized). If foreign banks are allowed to operate in Iraq – as it should be expected in an open economy, and as provided for in the draft revised commercial bank law -- the number of banks in the country would be sufficient to provide the banking services needed to sustain economic development. The size of the market would be such as to allow domestic banks an adequate business base that would ensure commercial sustainability and potential for growth.

IV. BUDGET ESTIMATES FOR THE BANKING SECTOR

43. Preliminary cost estimates – detailed in Annex 2 – were drawn regarding expenditures to be incurred primarily in calendar year 2004. These would cover (i) the needs of the state-owned banks (including CY2004 current expenditures, the rehabilitation of the branch network and technology upgrading, and the costs related to the management contracts for Rafidain, Rasheed and two state-owned specialized banks) and (ii) the costs of capacity building in banking supervision. Work related to developing an adequate non-cash payment system in Iraq (to be initiated in 2004) has yet to be assessed for the purpose of cost estimates. The overall financial envelope is estimated at US$104 million out of which an amount of US$94 million would be expended in 2004, and the balance of US$10 million in 2005 and subsequent years. Total expenditures would be distributed as follows:

(i) US$23 million would defray the 2004 current expenditures (staff salaries) at state-owned banks.
(ii) US$12 million would cover the outstanding costs of rehabilitation of bank premises (after-war related destruction and wear and tear).
(iii) US$33 million would cover the capital costs of infrastructure and technology upgrade at (including related staff training) at state-owned banks.
(iv) US$27 million would fund the management contracts (over 2004 and 2005) for Rafidain, Rasheed and two state-owned specialized banks.
(v) US$9 million, mostly in 2004, to build the banking supervision function at the Central Bank.

44. The question may be raised about the potential cost of bank recapitalization. Under a scenario where there is no cancellation of intra-government debt, the amount of new capital needed by state-owned banks would be small as it would mainly depend upon how much provisions would have to be made for non-performing loans. This is unlikely to be a major expense item given the negligible size of the bank loan portfolios. The main issue would not be capital availability, but rather the ability of banks in the medium-term (6 to 12 months) to turn the treasury bills which represent the bulk of their assets into cash so that new loans can be provided to the private sector. Under a scenario of debt cancellation, the amount of capital needed would be equal to the amount of Treasury bills and other government bonds that would be cancelled. As such this would have a neutral effect in terms of budgetary outlays.

V. CONCLUSION

45. Considerable assistance for capacity building – in terms of human resources and skills, technology and systems, legal framework and banking regulation, supervision and enforcement, payment systems, accounting and auditing – would be needed to move Iraq's financial system forward. This assistance would help to rehabilitate and restructure existing institutions and introduce the main and essential concepts of a modern banking structure where banks assess, price and manage risk, rather than act merely as paying or receiving agents for the government in its dealing with the state-owned enterprise sector. In the ensuing stage, the needs in the non-bank financial sector – insurance and capital markets – would have to be addressed. In the context of the major effort that would be needed, the World Bank could assist directly as well as enlist regional participation and support.

Annex 1

Iraqi Chartered Banks

I - Public sector banks

Rafidain Bank
Rasheed Bank
Agriculture Cooperative Bank
(Real) Estate Bank
Industrial Bank of Iraq
Ishitiraki (Socialist) Bank

II - Private sector banks

Al-Baraka for Investment and Financing Bank
Bank of Babel
Bank of Baghdad
Basra Private Bank for Investment
Commercial Bank of Iraq
Credit Bank of Iraq
Dar Es Salaam Investment Bank
Economic Bank for Investment and Finance
Gulf Commercial Bank
Investment Bank of Iraq
Iraqi Islamic Bank for Investment and Development
Iraqi Middle East Investment Bank
National Agriculture Bank for Investment and Development
Sumer Commercial Bank
United Bank for Investment
Warka Investment Bank

Annex 2 (a)

Budget Estimates for the Banking Sector
(assuming initiation in CY 2004)
(in US$ Million)

State-Owned Banks

Staff Expenditure for Rafidain and Rasheed	@$125.00 p.m. X 12 X 13,400 staff	20.1 million
Staff Expenditure for 4 specialized banks	@$125.00 p.m. X 12 X 2,000 staff	3.0 million
Current Expenditures for 6 State-Owned banks* (CY2004)		23.1 million
Refurbishing destroyed branches	@ $25,000 per branch X 100 branches	2.5 million
Upgrading non-destroyed branches	@ $10,000 per branch X 150 branches	1.5 million
Refurbishing H.Q. @ $2.0 million per bank – 4 banks*		8.0 million
Refurbishing bank premises		12 million
Establishing on-line banking system @$5,000 per branch X 459 branches		2.3 million
Connecting on-line banking system with H.O. @$1.0 million per bank – 4 banks*		4.0 million
Staff training - on-line system		2.0 million
IT infrastructure for acc., credit, ALM, at H.O. @$4.0 million per bank – 4 banks*		16.0 million
IT infrastructure at branches @$12,000 per branch X 459 branches		5.5 million
Cost of staff training - new procedures, equipments, etc.		3.0 million
Capital costs of infrastructure & technology Upgrade (incl. staff training)		32.8 million
Mgmt contract for Rafidain and Rasheed - Diagnostic study & reports		3.0 million**
Mgmt contract for 2 years minimum 8 persons per bank @$300,000 p.p. per year		10.6 million
Mgmt contract for 2 state-owned specialized banks* - Diagnostic study & reports		3.0 million
Mgmt contract for 2 years minimum 8 persons per bank @$300,000 p.p. per year		10.6 million
Management Contracts		27.2 million
Total State-Owned Bank Restructuring and Management (Of which US$ 9.6 million to be incurred in CY2005)		**95.1 million**
Bank Restructuring and Management Net of Recurrent Costs		**72 million**

* This assumes that 4 state-owned specialized banks will be merged into 2 banks with no branch closures. Some of the Rafidain and Rasheed branches will be transferred to the two new merged banks.

** 12 persons @ of $1,000 per day for 120 days times 2 banks.

Annex 2 (b)

Budget Estimates for Banking Supervision

(assuming initiation in CY 2004)
(in US$ Million)

Banking Supervision

Hiring one resident adviser for three years @$300,000 per year	$0.9 million
Establishing a data base	2.0 million
Consulting services - develop on-site examination procedures, MIS, regulations, supervisory framework, on-site and off-site manuals, etc.	3.0 million
Establishing an IT infrastructure	1.0 million
Training	1.5 million
Total Banking Supervision (out of which US$0.3 million each in 2005 and 2006)	**8.4 million**