Financing the future of Iraq

FINANCIAL ARCHITECTURE TO UNDERWRITE ECONOMIC REVIVAL BEGINS TO TAKE SHAPE

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Poised for prosperity

FEARS OVER SECURITY, A CONFUSED LEGAL SYSTEM, POLITICAL UNCERTAINTY... THE BANKS CONTINUING TO GIVE IRAQ A WIDE BERTH COULD BE FORGIVEN FOR THINKING THAT VERY LITTLE HAS CHANGED OVER THE PAST FEW YEARS. HOWEVER, A VISIT TO THE COUNTRY PAINTS AN ALTOGETHER MORE OPTIMISTIC PICTURE. **COURTNEY FINGAR** REPORTS FROM BAGHDAD

One thousand years ago, and for several generations, Baghdad was the world's richest city. Iraq's capital city and commercial heart has a long road to travel to get back to anywhere near the global prominence it held in those dim, distant days – no small understatement intended – but even its current unpleasant notoriety has a feel of edgy excitement, of a place on the verge of a gold rush. It is intoxicating in an inexplicable way.

Despite a political stalemate that has dragged on since elections were held in March, with no new government yet to emerge, and despite continuing incidences of violence, Iraq is of considerable interest to investors and GDP growth is predicted to surpass 7% this year, powered by oil money.

"With FDI being a major factor affecting the growth of the Iraqi economy, it is safe to say that multinationals from different industries are beginning to take major interest in Iraq. Backed by massive oil fields and multinationals interested in developing oil services, infrastructure and construction projects, long-term potential could be massive," says Abdel Hamid Shoman, executive chairman of Arab Bank, which has acquired a banking licence for Iraq.

Kyle Stelma, managing director of Dunia Frontier Consultants, says in the past six months his group has noticed a clear shift in investor attitudes towards Iraq and more private equity firms are beginning to take a serious look at the market. He expects "a massive uptick in FDI" as soon as the government forms, which most observers expect to happen in September or October.

But a mercantile infrastructure must be built, and quickly, for when the gold rush begins.

"Without real financial institutions and banking in Iraq nobody can work," says Kais Kubba, chairman of Credit Bank of Iraq, a private bank that is majority-owned National Bank of Kuwait.

The signing of contracts with international oil companies and the entering of the market by these major firms – as well as the wave of follow-on investment their arrival portends – has put sudden pressure on a weak and unsophisticated banking sector, which will need to rapidly get up to speed.

Many of Iraq's 30-odd banks are small, family-owned operations that function as little more than money shops. The landscape is dominated by state-owned banks: the three largest, Rafidain, Rasheed and TBI, account for anywhere from 85% to 95% of banking sector assets in terms of book value and roughly the same percentage of deposits.

There is very little true financial intermediation. Banks in Iraq offer a traditional range of deposit accounts and lending products including, relatively recently, debit and credit cards as well as exchange and transfer facilities. The vast majority of banking operations are confined to basic consumer transactions and banks derive most of their income from fee-based services such as money transfers.

"The problem of the banks in Iraq is there are a lot of small boutique banks with limited capital which are controlled by families and they're using all the money and the banks for their own businesses. There is no cover and no security for certain banks – I am not talking about our bank or the HSBC bank in Iraq, because we have already got the relationships with the major banks – but the rest of the banks are facing a lot of troubles because they cannot open letters of credit from their banks to the world. They must go through Jordan or through Lebanon, which is costing a lot of money and fees. And the interest rate is too high in Iraq. Sometimes it's 15% and sometimes it's 20%," says Mr Kubba.

Struggling to meet demand

As a market, Iraq is seriously under banked. Demand for banking services is outstripping existing capacity and penetration is low. Nearly every segment of banking is ripe for development and financing gaps are opening up all over the place. Project finance is in short supply, putting at risk the ambitious building projects as construction companies struggle to come up with the short-term financing required. There is obvious potential demand for Islamic finance products, given that 97% of the Iraqi population is Muslim. A handful of Islamic banks have registered in Iraq in an attempt to capture this market.

Same old story? a security guard stands outside one of Iraq's regional banks. Such scenes have put off some foreign banks when it comes to investing in the country, but away from the headlines, the Iraq's security situation is much improved

"What we're seeing is appetite for medium tenor financing – five to seven years is available. But there is a major gap in the demand versus supply. We're talking about a tens of billions of dollars requirement of financing from the private sector, public sector and multinationals," says Hussain Ali Qaragholi, Iraq business head for Abu Dhabi Islamic Bank, which is planning to open its first branch in Iraq. "There is certainly appetite for the market. The record speaks for itself – we've had announcements of European, American and Asian companies that have committed to coming into Iraq and with these deals there is finance that is involved."

But Iraq is still a cash economy and many citizens distrust banks, preferring instead to keep their cash tucked away under the proverbial mattress – a throwback to the Saddam Hussein era, when the leader could confiscate deposits at will. There is no such thing as a credit information bureau in Iraq – or really any formal system of credit checks – and banking is very much a personal business. Technology is poor, and most state-owned banks do not even have core banking systems. Private banks are not always up to speed with basic banking products either. There is no proper rating criteria for banks (instead an old-fashioned ratings system called Camel is used) and there is a lack of expertise among managers, many of whom are nearing retirement age.

"People do not trust the banks – this goes back to the 1960s and 1970s. Equally, banking needs to prove itself as a qualified sector in dealing with people," says Dr Salam Smeasim, a well-regarded Iraqi economist and a member of the Iraqi Securities Commission. "Many of the young staff are well computerised and open-minded, but sometimes the problem is the management, because you can have good human resources, but that doesn't help if you don't know how to manage them. This is a problem not just for banking but in all of Iraq."

The same issues that make the general business environment difficult impede the proper functioning of the banking system: an overbearing public sector; inconsistent legal and regulatory frameworks; and human-resources issues including poor customer service and risk management cultures.

Business struggles

Corruption remains rife in Iraq, and the financial sector presents many opportunities for pocket-lining and favour-currying, and thus legal landmines for international investors. The Transparency International Global Corruption Report 2009 puts Iraq 178th out of 180 countries. The World Bank's Doing Business 2010 report lists Iraq as among the worst countries in the world for starting a business, getting credit and enforcing contracts.

"I have seen companies innocently run afoul of the Iraqi banking and regulatory system - the system is nascent and there is confusion on all sides," says David Jansen, leader of PricewaterhouseCoopers' anti-corruption practice. "My advice to corporate executives is to obtain international crossborder financial and legal advisers who have professionals on the ground in Iraq experienced in working with officials in the finance or investment ministries. In addition to Iraqi regulations, laws in the UK, US and elsewhere require careful and robust due diligence."

Iraq enacted legislation six years ago allowing foreign banks to operate freely in the country but while various foreign banks are circling around – camped out in Amman or other surrounding, safer areas – or are seeking out correspondent relationships with local banks, few have planted flags on the ground in Iraq. Regional banks have led the first wave in, with Lebanese and Iranian banks, as well ▶

COUNTRY PROFILE

IRAQ

Population:	30 million
Pop. growth rate:	2.5%
Area:	438,000 sq km
Real GDP growth:	4.3%
GDP per capital:	$3600
Labour force:	8.1 million
Unemployment rate:	15.2%

Source: CIA World Factbook, August 2010

as Bahraini, Kuwaiti and Turkish institutions, among others, active; their approach towards Iraq, on the whole, has been interested yet cautious.

For all its espoused bullishness on Iraq, Arab Bank has not yet utilised its licence due to lingering security concerns. "We used to have a presence in Iraq before being nationalised there. We obtained the licence due to our belief that there is potential in the country... but the financial crisis has inhibited many companies in expanding. Hopefully things will improve, and once they do, we will look into re-entering Iraq," says Mr Shoman.

Speaking to local media, Mudhhir Mohammed Saleh, a member of the CBI's board of advisers, attributed foreign banks' temerity in Iraq to not only security concerns but also the lack of a favourable legal framework. The outgoing parliament failed to pass a new banking law, kicking the ball to the new legislature, whenever it should be seated.

Banks from outside the Middle East have been even more reluctant to go all-in. Of these, HSBC has been the pioneer, taking a majority stake in Dar Es Salaam Bank and dispatching an Irish executive to oversee the set-up as CEO for Iraq. James Hogan says the bank will have invested capital expenditure of $220m in its Iraq business within the next few years and hopes eventually to expand from debt-provision services for its corporate clients to capital-raising. "In time we could see some of the advisory work we are doing in Dubai could be done onshore in Baghdad," he says. "We will have fewer security people and more banking advisers on the ground here."

HSBC will likely be alone among Western institutions actually based in Iraq for a while yet – a first-mover advantage it fully intends to exploit once the late-comers arrive – although Citibank, for one, looks ready to make a move: the CEO of the bank's operations in Bahrain is reportedly being brought over to Jordan to run an Iraq-focused unit out of Amman.

Capital market option

Because the banking system is still so underdeveloped, capital markets are viewed as another important mechanism for expanding the economy and supporting business.

The Iraqi Stock Exchange (ISX) was launched in 2004, set up as an non-governmental organisation in order to be able to tap donor money; it is now doing automated trading and holds five sessions from Sunday to Thursday. Eighty-five companies have listed on the ISX, although 19 were recently suspended for late filings of financial statements. Results for 2009 were positive, with a 40% increase in trading volumes over 2008, and the first half of 2010 was strong as well, but investors have become nervous about the long delay in a government forming among other factors, says Taha A Abdulsalam, CEO of the exchange. Their chief worry is over the decision by the Central Bank of Iraq (CBI) to force banks to raise their minimum capital to ID250bn ($211.5m). "This is a problem for investors so they want to sell their shares in banks," he says.

Capital markets investors are not the only ones fretting about the new minimum capital requirements handed down by the CBI when it signed up to Basel II requirements in March. Understood as a way of forcing consolidation among banks, the requirements are bound to cause a shake-out. Most banks are currently only capitalised to the tune of about ID50bn to ID60bn, and were already struggling after the gravy train of 23% interest rates they had been living off of came to a halt when rates were lowered earlier this year to a leaner 6% to 8%.

The decision aims to strengthen the banks as the current lack of capital decreases the financing capability for economic development purposes, a CBI adviser told local media in March. "Banks in general do not have a role in the investment field despite [the fact that] they enjoy a liquidity percentage which reaches more than 60%, and we cannot pressure banks in this critical situation as the decision will make banks stronger and with more capital, which will increase their capabilities in lending," Mathhar Mohammad Saleh told Aswat al-Iraq news agency. "The decision will contribute to increasing the financial resources to serve the economic development in the country as most of the Iraqi banks' capital does not exceed $50m, which can't do anything regarding the development projects."

But some disgruntled bankers suggest a shake-down is in order as much as a shake-up. One of the largest private sector local banks, Warka, recently had to hand back sizeable government deposits upon demand and was ordered to close 87 of its 130 branches (a decision later reversed). Publicity surrounding these events caused depositors to do a run on the bank, which is still standing but says its would more than welcome a foreign investor or foreign bank that wanted to partner and take advantage of its extensive reach across Iraq, strong customer knowledge and comparative technical competence. "I don't think any other bank would have survived," says chairman Saad Al Bunia.

Asked if it would continue to survive, he replies: "We have to."

Others will not. But Warka's woes aside, consolidation, even if forced, is bound to be for the betterment of the sector by and large. "Based on the guidance and instructions issued by the executive authority in Iraq, which aims to stimulate the effectiveness of this sector, in the future there will be vital and active private banks," says Kareem Noor Alyasir, vice-chairman of North Bank.

Kamil Gailana, former finance minister of Iraq who now works as a consultant, puts it more succinctly. "It's better to have a few private banks working in a professional way than 29 that aren't really doing anything," he says. ■

TAPPING INTO IRAQ'S POTENTIAL

Trade Bank of Iraq is playing a key role in financing the rebuilding of the Middle Eastern country and rejuvenating its banking sector, showing the way forward for foreign banks tempted by the lure of Iraq's unparalleled potential

One of the great clichés of the 21st century so far is that the balance of power in business, investment and trade is switching from the Western markets to the emerging markets.

But not all emerging markets are equally promising. As George Orwell might have put it, some are "more equal than others".

Those that are rich in natural and human resources – as measured by educational attainment – have a natural edge over the rest. Judged on these criteria, few, if any, can match Iraq.

The fact that this is not yet a truth universally acknowledged means that an international bank or business alert enough to identify the opportunity can secure a priceless first-mover advantage.

VOYAGE OF RECOVERY

Perceptions often lag behind reality. Companies risk losing business if they cling to the outdated perception that Iraq is a war-torn country. The reality for Germany, Japan, South Korea and Vietnam is that these were all war-torn countries that recovered, grew and became magnets for investment and trade. None of them is now defined by the violence that once ruined their economies.

Iraq is undertaking the same voyage of recovery and is more favourably placed than any of these at a similar post-war stage. Iraq's advantage is that it is better resourced, especially in terms of its valuable oil and gas reserves, in a world hungry for energy.

Violence continues but it is becoming increasingly localised as more and more towns and cities revert to a peaceful existence. There's still a long way to go to total normality, but the evidence of progress is all around in the form of new power stations, new bank branches and new private businesses.

At the heart of the recovery is the oil sector. That, inevitably, is where the biggest projects are. The signing of the second round of oil licensing agreements is having a spectacular multiplier effect on the private sector. More and more private businesses are benefiting from these contracts by providing services to the big oil corporations that won the licence round.

Like other Middle Eastern oil and gas countries, Iraq is no longer content to export oil and spend the money on imports of goods and services. Times have changed and the new Iraq is more of an investment economy.

It is also more of a private enterprise economy than a state-controlled economy. Big projects are coming on-stream in the private sector as well as the public sector. For example, in two or three years, more power plants will be in the private sector than under state control.

Iraq's new market economy has its foundations in energy. But it is also diversifying into agriculture, infrastructure, construction and housing, health, telecoms – and even tourism, as more regions grow tranquil.

All this means there are big projects to bid for and big projects to be financed. Project finance is becoming of critical importance.

FINDING A WAY IN

But Iraq's financial series framework still has gaps and shortcomings. Finding the right route to this ripening market is essential. The most accessible bridge linking Iraq to international financial institutions and businesses is the Trade Bank of Iraq (TBI).

> "COMPANIES RISK LOSING BUSINESS IF THEY CLING TO THE OUTDATED PERCEPTION THAT IRAQ IS A WAR-TORN COUNTRY... GERMANY, JAPAN, SOUTH KOREA AND VIETNAM ALL RECOVERED, GREW AND BECAME MAGNETS FOR INVESTMENT AND TRADE"

The TBI itself embodies the transformation in Iraq's fortunes. Back in 2003 it was set up by the Ministry of Finance and led by Hussein Al-Uzri, still its chairman and president, as an independent state-owned bank operating to international standards to finance Iraq's humanitarian and reconstruction needs through regular banking channels.

Now its role is to facilitate increasingly sophisticated relationships between Iraqi businesses and international partners. They have a mutual benefit in growing the Iraq economy and in seeing the removal of obstacles preventing this aspiration becoming reality.

One big obstacle used to be the shortage of letters of credit. Iraqi businesses found themselves unable to sell their goods abroad. That obstacle is being bulldozed out of the way. In 2009, TBI issued more than $10bn in letters of credit. Other banks are joining in.

A major international beneficiary has

Going up in the world: TBI is helping to fund the rebuilding of Iraq, with projects such as the Erbil power station (left) and the Millennium Hotel, Sulaimaniya

been General Electric, and its domestic co-beneficiary has been the energy infrastructure business. JPMorgan partnered TBI in a complex deal on a tight schedule to agree a $3bn letter of credit for the purchase of power equipment for 7000 megawatts of multi-fuel gas turbines from General Electric.

A simple sale of turbines would not have been enough for what was still a fledgling domestic industry, so the deal also provided for technical advisory services, staff training, spare parts and performance testing. And the indirect beneficiaries are the businesses liberated from brownouts and the families freed from energy rationing. With the new capacity in place, millions of people and thousands of businesses can look forward to a reliable service from their electricity utilities. In turn, this will release pent-up demand for consumer goods and provide new sales opportunities for enterprising companies.

OPEN DOOR POLICY

Project finance is just as crucial as letters of credit, especially for the oil business. The TBI is working with international banks on a range of projects. It is also in conversations with national and regional banks, and with export credit agencies and multilateral agencies.

Iraq has an open door policy towards foreign banks. Some, such as Standard Chartered, Deutsche and HSBC, are already settled in and developing a growing business stream. The opportunity for partnerships and for initiatives is huge because, for years, Iraq was drastically underbanked – it did not even have a recognisable personal or small business banking system. In this sphere, too, the TBI is working with other domestic banks to upgrade the whole banking industry, so as to provide the financial services needed by businesses and families alike.

Encouragingly, there has been a flow of investment into state-of-the-art online, mobile and bank card systems. As a result, Iraq is well positioned to advance from a near-medieval cash economy to a future-oriented electronic banking system, with minimal reliance on cheque books and paper-based banking.

This is the sort of development that is securing and facilitating long-term economic growth. Both the oil industry and the increases in FDI, especially in infrastructure and energy projects, indicate that growth in the year ahead is likely to pick up.

The recovery in oil revenues should narrow the fiscal deficit to a small percentage that most developed economies would greatly envy. While other countries have to watch their oil reserves dwindle, Iraq's oilfields have massive reserves and a spectacular increase in oil production is anticipated over the next few years from the international companies that won the bidding rounds. Within a few years, production of 12 million barrels a day is an ambitious but attainable goal.

Little anxiety need be felt about the health of the current account or about the availability of revenue to underpin infrastructure investment and industrial diversification. Iraq has arguably become the pick of the newly emerging economies.

As TBI's Mr Al-Uzri puts it: "Iraq is a country rich in resources and investment opportunities and is well placed to become the world's fastest emerging economy."

"IRAQ'S NEW MARKET ECONOMY HAS ITS FOUNDATIONS IN ENERGY. BUT IT IS ALSO DIVERSIFYING INTO AGRICULTURE, INFRASTRUCTURE, CONSTRUCTION AND HOUSING, HEALTH, TELECOMS – AND EVEN TOURISM"

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TRADE BANK OF IRAQ

Calmer waters

ALTHOUGH HIGH-PROFILE, DEADLY ATTACKS ARE STILL TAKING PLACE IN IRAQ, SECURITY EXPERTS AND STATISTICS SAY THAT THE COUNTRY'S SECURITY CONTINUES TO IMPROVE, REPORTS **COURTNEY FINGAR**

Double suicide attacks that blasted the Trade Bank of Iraq headquarters and killed nearly 30 people in July, following an assault on the Central Bank of Iraq involving bombers and gunmen the previous month in which 20 people died, rattled nerves and served as a deadly reminder that Iraq's financial sector remains in the crosshairs of militant groups looking to destabilise the country.

These lethal events aside, the perception of worsening security in Iraq is largely inaccurate, argues Dr Michael Knights, vice-president of analysis for security firm Olive Group. The perception stems from the relatively high number of attempted mass-casualty attacks this summer by Sunni extremist groups and the high profile garnered by such attacks, he says.

This matches the assessment of other security analysts active in Iraq. Andy Edwards, CEO of Consilium Risk Strategies, says: "Despite the recent and very regrettable violence in Iraq, the situation is slowly improving and is now dramatically better for business than when we first began to work in Iraq [in 2003]."

A welcome drop

On a statistical basis, general violence is narrowing and thinning out significantly.

There were 332 officially reported incidents (defined as an enemy-initiated attack, arrest operation or serious crime) across Iraq in July 2010. The figure of 332 incidents in July is a decrease from 479 in June, 595 in May and 637 in April.

"If official incident levels are accurate, violence is dropping well below the pre-election [March 2010] tempo and is indeed the lowest recorded level since April 2003. This means fewer incidents in each neighbourhood and a gradual return of normality, relative to earlier years at least," says Mr Knights.

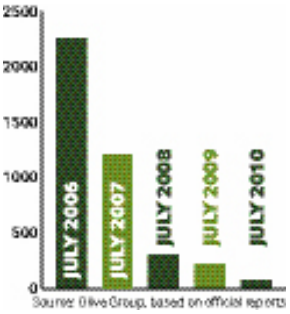
Getting there: though there are still some high-profile attacks by insurgent groups in Iraq, the security forces in the country are making progress, such as the weapon finds pictured above

Quieter in Baghdad

The capital is also getting safer month by month. For anyone sitting on a city rooftop in the evening, the sound of bangs (bombs) and cracks (gunfire) is no longer a given. Baghdad witnessed a second consecutive month of steeply reduced violence in July 2010, with only 71 incidents reported from the joint US-Iraqi reporting system. This is the lowest level since collection of incident figures began in 2003.

Baghdad does see waves of violence depending on the security and political climate and there are minor local fluctuations, but the year-on-year trends are encouraging (see chart).

NUMBER OF REPORTED SECURITY INCIDENTS, BAGHDAD



Financiers, investors and business partners from abroad will need to be aware of the vulnerability of the bank offices and other facilities that they may need to visit when doing deals in Baghdad – which, all things being relative in a highly fluid and occasionally volatile situation, is not necessarily any greater than that of many other potential targets of violence in the country.

"Financial institutions in Iraq [such as the trade bank and central bank] are as safe to visit as any other major government installations. They stand about the same chance of suffering a major attack as major hotels or ministry buildings, which is to say that you would have to be very unlucky to be in exactly the wrong place when an attacker strikes," says Mr Knights.

"Statistically, the number of effective attacks on such institutions can be counted on the fingers of one hand at the end of a seven-year insurgency.

"The key is to insure your visit with an experienced security team, which will minimise the time you spend in the car parks, lobbies and other vulnerable parts of such locations." ■

Shipping out: Iraqi exports are loaded from lorries onto a ship at the port of Umm Qasr. But a shortage of trade finance is holding back the flow of goods into and out of the country

Credit check

IRAQ'S IMPORTERS AND EXPORTERS ARE IN DESPERATE NEED OF TRADE FINANCE BUT THE COUNTRY'S BANKS ARE STRUGGLING TO MEET THIS DEMAND, REPORTS **COURTNEY FINGAR**

Iraq imports approximately half of its consumable goods, making trade finance a must; and Iraqi companies, now that they have access to international commerce again after decades of isolation, are eager to get their goods out to market.

In theory, all banks in Iraq provide trade services to companies wanting to trade internationally, including transfers, letters of credit (LCs) and letters of guarantee. In practice, however, it is more complicated.

Few banks in Iraq offer credit on an unsecured basis. The credit that is available is based on loan collateral, often secured by cash, gold or land (the latter of which involves a slightly complicated process of registering and pledging real estate to banks in order to obtain financing). There is little or no credit or cash-flow analysis. LCs can be hard to come by for many Iraqi companies, although they are more pervasive than in previous years.

"Letters of credit are one of the most important issues for Iraq to deal with. In 2009, the Trade Bank of Iraq [TBI] issued more than $10bn in LCs. Other banks are doing the same," says TBI chairman Hussein Al Uzri. "Back in 2003, the only way to finance trade was through the oil-for-food programme; now we see that we are backing LCs, except for oil. So that's big progress."

TBI dominates market

TBI, a state bank claiming total assets of more than $10bn, is the major player in providing trade finance services in Iraq – or, as one Iraqi financial player describes the bank, the market's "400-pound gorilla".

Established in 2003 to issue LCs and facilitate imports for the government of Iraq for an originally specified two-year period, TBI is now a fully functioning bank by any definition, having introduced ATMs to Iraq and now issuing credit cards; it has nine branches and is set to add another five this year. The bank recently implemented a multi-currency retail banking solution, Misys Equation, which it says will facilitate TBI transactions across the country and allow customers to access real-time information about their accounts. Previously, each branch used stand-alone offline systems, and daily transactions at branches were consolidated at the end of the day.

TBI has been raising its limits – now offering LCs of up to $2m to private banks – to increase the capacity of private banks to issue LCs. But many of these banks complain that the LC business is not trickling down and that they are in a sense competing, in vain, with the government. And some observers cast doubt on the creditworthiness of the Iraqi government itself as backer of the trade papers. "Because of the large size of many of the letters of credit that are going through the government, people are sometimes even worried about those getting paid, let alone everyone else's LCs," says a US official involved with trade issues.

In any case, not enough of Iraq's banks possess the technical ability or correspondent-bank relationships to handle a great deal of LC business. As Iraqi private banks do not tend to have a lot of credit established with international banks, if one of them wants to facilitate an LC somewhere in the world, it may only have, for ▶

example, $200,000-worth of credit with whichever correspondent bank that LC has to go through. So if the bank puts out that $200,000, it cannot extend any more credit through that correspondent bank until the $200,000 LC is paid off; hence, a credit crunch ensues.

Even those Iraqi banks with solid international links, such as Dar Es Salaam Bank, of which HSBC is now a majority owner, say they cannot get their hands on enough paper. "LC volumes are not as high as we would like because the business is limited to private sector deals and because of the near monopoly of the government bank. We are seeing double-digit growth but in absolute size it is still very small," says James Hogan, the Iraq CEO for HSBC Middle East.

US boost for imports

On the import side, at least, Iraqi buyers may soon find it a bit easier to procure goods from the US. In July the Export-Import Bank of the US (Ex-Im Bank), which had previously been closed to Iraqi businesses, announced that it would finance short-term and medium-term sales of US exports to Iraqi buyers in both the public and private sectors.

"Iraq's economy is growing, offering specific opportunities for US exporters in a variety of industries. Ex-Im Bank can help by reducing the repayment risk, especially for small businesses," says Ex-Im Bank board member Bijan R Kian.

Ex-Im Bank says it will provide export-credit insurance, loan guarantees and direct loans for creditworthy export sales to Iraq. Short-term insurance is available for transactions with repayment terms of 180 days or less, and up to 360 days for capital goods. Medium-term insurance, loan guarantees and loans are available for transactions with terms of up to seven years. The bank's working capital guarantees (which help US exporters or their suppliers to obtain funds to produce or buy goods or services for export) are available to support exports to Iraq.

"The bank will consider providing long-term support where there are financing arrangements that eliminate or externalise country risks, such as asset-backed financings and structures that earn revenues offshore in a third country," said Ex-Im Bank in announcing the development.

As it stands now, if a US company wants to sell something to an individual Iraqi company, it is nearly impossible without going through TBI. Most LCs have to be 100% collateralised, which greatly restricts the initial size of the LC that the Iraqi buyer can receive for the transaction. US exporters complain that trade transactions with Iraq often fall apart because of a catch-22 situation whereby the LC does not clear because it is extremely costly to get guarantees on the paper, and so the Iraqi company does not want to pay it and neither does the US firm.

Ex-Im Bank stepping into the breech is a development that could, at least in part, help unblock the logjam in US-Iraq trade. As for freeing up the market for Iraqi trade business to and from other countries, the request from many corners, realistic or not, is for the government to do the opposite and step aside. ■

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Ripe for reform: Iraq's public banks, such as Rafidain Bank (left), the Central Bank of Iraq (above right) and Iraq's capital markets (Iraq Stock Exchange pictured bottom right) are all being targeted for reform in a wide-ranging – but so far slow-moving – reorganisation of the country's financial system

Stunted growth

IRAQ'S FINANCIAL INSTITUTIONS HAVE MADE FRUSTRATINGLY SLOW PROGRESS IN RESOLVING THEIR PROBLEMS AND INTEGRATING INTO THE GLOBAL ECONOMY, BUT THE WORLD SHOULD NOT LOSE SIGHT OF THE SIGNIFICANT ACHIEVEMENTS MADE SINCE 2003, REPORTS **COURTNEY FINGAR**

In Iraq, life sometimes moves in rapid-fire motion and developments happen at such a pace that it is almost impossible to keep up. Viewed with the proper perspective of time and place, it is startling what has been achieved in remaking the country, its government system and its economy since the invasion by US-led coalition forces in 2003.

In seven years, a 35-year-old autocratic regime has been dismembered and replaced with a messy multi-party democracy, a statist economy has been sent into an even messier transition towards a free market, and massive volumes of laws have been torn up and rewritten. The wheels of change are turning, even if they often grind to a halt before starting up again, and all the while there is frustration and impatience that changes are not happening as quickly and comprehensively as needed.

Bureaucratic roadblocks

Consider the case of a multilateral institution-led reform project for elements of the banking sector. In December 2006 there was an agreement between the Central Bank of Iraq (CBI) and the International Monetary Fund over steps to be taken to reform the banking sector, focusing in particular on the public banks. For the next two years, despite some baby steps, progress was halting as reformers ran up against bureaucratic roadblocks. The World Bank stepped in with a $10m grant in April last year to fund implementation.

After months of diligent work, all the documentation was prepared for a programme that would see the supervision department of the CBI reorganised and training provided for all CBI staff that deal with supervision – 105 people in total. The training was due to start in September 2010 and, ahead of that, all the contracts were to be finalised at the end of June. But on June 13 there was an attack on the CBI and all the documents were destroyed – rather conveniently, some murmured. All the documents are now being replaced.

"The target [for completion of the CBI reorganisation and training] was the end of this year but, due to the circumstances, the World Bank has extended the project to June 2013," says Dr Majid M H Al Soori, the mild-mannered PhD in economics who ▶

Iraqi dinars stacked at a bank teller's window. Over the past seven years, much has been achieved in Iraq in setting up a financial system that meets international standards, but a great deal of reform is still needed to ensure a sustainable financial sector.

has been tasked with overseeing the project and liaising between the CBI and the World Bank.

He rejects any suggestion, however, that the attack on the CBI was motivated by malfeasance. "There is corruption in all government departments and sectors. But the aim of the attack was just to show that the terrorists can enter anywhere, any time, and to give the appearance that the government cannot control everything. It was the same as the attacks on the ministries of finance and trade," says Mr Al Soori.

Conflict of interests

There are calls for a wider overhaul of the CBI and a reset of its approach. Iraqi private bankers complain that it shows favouritism and accuse some CBI officials of conflicts of interest, charges that are hotly denied. "The CBI, and the government generally, needs to function as a regulator, not a competitor," says one well-placed player in the Iraqi financial industry.

"A very independent central bank that has jurisdiction over all banks" is the single biggest reform needed to aid Iraq's banking sector, agrees James Hogan, CEO for Iraq at HSBC Middle East. "You sometimes get a sense that there are two sets of rules and there are inconsistencies on some occasions," he says, while adding that on the whole he finds CBI staff "very supportive, responsive and well trained". HSBC plans to work with the CBI to provide risk-management training for its employees as well as for local banks.

HSBC has also been pushing, along with others, for the creation of a custodian bank to underpin the development of Iraqi capital markets – the current lack of which is cutting off Iraq from institutional investors, since many of the major funds, including US-based mutual funds, are barred from investing in stock exchanges without custodian services.

Taha A Abdulsalam, CEO of the Iraqi Stock Exchange (ISX), supports the idea of a custodian bank and says there has been a board meeting to draft such a recommendation to the Iraqi Securities Commission. "This is something new for Iraq and for ISX, but we must follow the same procedures as others. We plan to accept many banks, not just one, to provide these [custodian] services."

The second plank of the World Bank's reform project, meanwhile, involves the two large state-owned banks, Rafidain and Rasheed, and focuses on organisational restructuring, financial restructuring and capacity building; this has been pushed back five months.

Reform of some type or another to the status and structure of Iraq's state banks is certain (and, many argue, imperative to the health of the whole banking sector); but it is not likely that the state banks' clout will be reduced to the level desired by their private sector counterparts.

"The pervasiveness of state-owned banks in the Iraqi market is largely due to the fact that they are old and well-established," says Asif Al Masri, director of deals for Pricewaterhouse Coopers (PwC) in Jordan, who is involved in Iraq-focused projects. "The oldest public bank, the Agricultural Co-operation Bank, was established in 1935, whereas the Bank of Baghdad, the earliest of the private banking institutions, was established in 1992."

But the state banks have their problems. According to the CBI, the policy of aggressive lending adopted by state banks, which does not take into account appropriate credit-rating systems, is causing them to face high default risks.

THE MAIN THING IS TO RESTRUCTURE THE MENTALITY AS WELL AS THE PROCEDURES. THE MENTALITY IS VERY DIFFICULT TO CHANGE BECAUSE FOR 35 YEARS [IRAQI BANKERS] WERE ISOLATED FROM THE INTERNATIONAL SYSTEM

Article 16 of Iraq's banking law states that the minimum capital adequacy ratio for banks is 12%. However, several state banks are not meeting this requirement, making them vulnerable to liquidity risk, says PwC. In 2008, Rafidain's capital adequacy ratio stood at 2% while Rasheed's varied between 2% and 5%.

In an attempt to lower the risk levels faced by some state banks and increase their liquidity, both Rasheed and Rafidain increased their capital in 2008 to ID400bn ($340m) and ID500bn, respectively, causing the state banks' capital to form 50% of the total capital of banks in Iraq.

The banking law, drafted in 2003, was perhaps adequate for its purposes at the time, but now has weaknesses that must be addressed. As currently written, the law deals only with commercial banking – there is no mention of investment banking, Islamic finance or the development banks. A special legal programme is needed for the specialised agriculture, real estate and development banks, says Mr Al Soori, but establishing one is happening in "very slow motion".

There has also been talk of creating an Iraqi credit information bureau – another essential building block for the construction of an international-standard banking system.

Vision for privatisation

Privatisation in Iraq – of the several dozen state-owned companies as much as of the banks – has been widely talked about for years with nothing tangible yet on the table.

"In June 2010, the Iraqi government announced that there is a vision for privatisation; however, this will not be in accordance with the requests given by the World Bank. Privatisation will be done in stages and at a slow rate in order not to cause significant disturbances to the market, as the proposed privatisation projects currently employ more than half-a-million Iraqis and any fast movement towards privatisation will surely affect those workers," says PwC's Mr Al Masri.

This slow progress is a point worth expanding to apply to all categories of economic reform in Iraq. Many of the hurdles, such as endless red tape or insidious institutional corruption, are inexcusable and unnecessary, but they are administrative and thus easier to overcome than the mental blocks.

"The main thing is to restructure the mentality as well as the procedures," says Mr Al Soori. "And the mentality is very difficult to change because for 35 years [Iraqi bankers] were isolated from the international system."

A change in mindset is crucial, but so is patience on the part of observers, who must remember how radically Iraq's reality has been altered in less than a decade. At the political level, due to the recentness of the collapse of Iraq's command economy, "there is no common understanding about the market economy, investment or economic development", says Mr Al Soori. "This is the problem politicians are facing – if they don't understand the economic issues, how can they solve them?" ■

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The waiting game

THERE IS A LOT OF INTEREST FROM INSURANCE COMPANIES LOOKING TO SET UP OPERATIONS IN IRAQ BUT THE MARKET IS IN LIMBO DUE TO THE VOLATILE SECURITY SITUATION. IT IS HOPED THIS WILL CHANGE ONCE THE GOVERNMENT IS FORMED. **ABIGAIL FIELDING-SMITH** REPORTS

In theory, there ought to be a vibrant insurance market for companies seeking to operate in Iraq. Lucrative energy exploration and reconstruction work, particularly in the power sector, needs to be done at a time when security conditions are still uncertain. Premiums have come down since 2007 and the Export-Import Bank, which insures medium-term loans to support US exports, has just opened in Iraq following a re-evaluation of its risk ranking.

"Iraq is a high-growth market at a time when little growth is happening elsewhere," says Ali Al Saffar, Iraq analyst for research and advisory company Economist Intelligence Unit. "Once contracts are signed, I imagine premiums will steadily grow lower – Iraqi bond yields have been coming down."

In practice, however, the complexity of the risks involved means that most (but not all) corporate insurance underwriting, for political violence exposures at least, is being done by the Lloyd's market. There the mood, for the moment, remains cautious.

The supply of coverage for personnel, property and cargo has certainly become more sophisticated and flexible as brokers entering the Iraqi market have come to understand the situation better.

"When we first started arranging cover for operators of an armed convoy in Iraq it was a very high premium", says Andrew Pickthorn, principal of Integro Insurance. "Now more people can quantify the risk. It takes a while for the risk perception to meet the reality."

William Wakeham, managing director of AAIB, a Jordan-based broker firm with offices in Baghdad, Basra and Erbil, says that personal accident premiums have come down from 12% to about 2% for one of his clients in central Iraq. But improvements in the security situation are still seen by the markets as too sporadic to offer more long-term insurance products – such as political risk – at an economic rate.

Airline insurance also remains very expensive, and according to Terry Rolfe, who sources such insurance for clients at insurance brokers Integro, it is unlikely to come down without several consecutive months of relative stability.

Coral Parfitt, global insurance consultant for London-based brokers Bellwood Prestbury, says she does not anticipate a downward trend in premiums in the Iraq market, while Samer Awwa, vice-president of business development for brokers Aon in New York, says: "Commercial markets need to see improvements."

Sticking point

Political risk insurance (PRI) is available, says Mr Awwa, but it is difficult and expensive to obtain. Many big multinationals simply insure themselves. But, according to Llewellyn Werner, chairman of C3, an investment consortium specialising in conflict and post-conflict markets, the lack of economic PRI on the commercial markets is a major obstacle to investment in Iraq, even for companies with the balance sheet to insure themselves, as they prefer to have more than one layer of insurance.

High alert: the security situation remains volatile in Iraq

C3 is currently trying to put together a PRI package for its clients, together with Aon and an Iraqi partner organisation, but it is being held up by political stalemate following the March elections. "The greatest impediment to affordable PRI is the failure to form a government," says Mr Werner."

Market caution is "both a real and a perception problem", says Rod Morris, vice-president in charge of PRI at the Overseas Private Investment Corporation (OPIC), a self-sustaining US government agency that provides credit insurance in emerging markets. OPIC has not revised its Iraq rankings since 2003. Because part of its mandate is to support US foreign policy, however, it is more willing to take on risk than the commercial markets, though its preference for comprehensive coverage sometimes makes it more expensive.

According to Mr Werner, such interventions are no substitute for private sector involvement. "Having a quasi-governmental organisation provide this insurance is not expeditious," he says. "It must come from the private sector."

Although the basic suite of insurance products on offer – war and terrorism, cargo, kidnap and ransom, personal accident, Defense Base Act insurance (mandatory for personnel contracted by the US government), oil, airline, medical evacuation, political risk and liability – has not changed much since the start of the Iraq war in 2003,

Damage limitation: a worker makes repairs to the Al Doura power plant in Baghdad. Such reconstruction work ought to create a vibrant insurance market for firms looking to operate in Iraq

brokers have come up with various ways to improve service and rates.

AKE, for example, has intelligence reports sourced from the ground in Iraq, which, according to Fraser Newton, AKE's director of insurance, enables the firm to negotiate a better rate for clients with underwriters. Another way AKE tries to keep costs down is by 'packaging' clients together when approaching the underwriters. Government-funded work in Iraq is increasingly sub-contracted, which makes it harder for the individual subcontractors to get the kind of bulk discount available to large government orders.

An obvious gap in the supply chain is the lack of brokerage firms with a presence on the ground in Iraq. This presence is important not just to assess risk but also to service the client and ensure the smooth running of the subcontracted services in the event of a claim. When more companies are taking out credit risk insurance, it will also be important to have loss-adjusters and surveyors on the ground, too, says Andrew Pickthorn, calling this "a market that's developing".

Gap in the market

"What you need is someone who understands local environment, but who also understands the international insurance markets," says Jonathan Biles, a partner at broker firm Culver. Culver often partners with larger brokerage firms to provide on-the-ground client servicing, 'short-circuiting' the chain of subcontractors needed to get the level ▶

> IRAQ IS A HIGH-GROWTH MARKET AT A TIME WHEN LITTLE GROWTH IS HAPPENING ELSEWHERE

Flying high: airline insurance is expensive in Iraq and unlikely to come down until there is relative stability

of service clients require. "Someone actually needs to deliver the service, product or project on the ground," says Mr Biles. "It's something the Iraqis (and the Americans) have failed to grasp and has cost billions of dollars as the spiral of subcontractor to subcontractor leaches the original investment announced at government level. This is the gap in the market I have focused on."

Another firm that stresses the importance of being on the ground is AAIB, which has three offices in Iraq and started its own medical evacuation company, AlfaEvac, in 2006.

Both AAIB and Culver seek to add value by facilitating partnerships with local Iraqi insurance companies. For companies looking at a long-term presence in Iraq (and the banks that finance them), Iraqi participation in the risk provides extra reassurance, and some companies have a corporate ethos obligating them to work with local partners wherever possible.

Current legislation obliges companies to place the risk in the local market if capital and service are available to the same degree as outside, but this is widely expected to tighten after a new government is formed. "In Kuwait you have to place business through a local insurance company," says Michael Ellery, director of Anderson Lloyd International, a London-based broker offering insurance coverage in Iraq, "I'm sure it will change in the future so that we as brokers have some kind of Iraqi company to front it through."

According to AAIB's Mr Wakeham, foreign companies are already using AAIB to ensure compliance with local conditions because they believe the current legislation to be ambiguous. AAIB has been working to build the capacity of local insurance providers, which is currently very limited. The market is dominated by the three state-affiliated institutions, and thinly capitalised. "It won't happen overnight," says Mr Wakeham.

Growth area

Although these market gaps and growth areas ought to be attracting more brokers to Baghdad, the operating costs are high, and the expertise needed to operate on the ground is not easily accrued. It took AAIB almost two years just to get registered. Moreover, as Mr Wakeham points out: "There are not many practitioners that would want to be in Iraq."

Mr Biles estimates it will be another three to five years before big international brokers start setting up a permanent presence in Baghdad.

Another growth area, at least according to one broker, is liability insurance. "There is a bit more regulation in Iraq," explains Anderson Lloyd's Mr Ellery, "and we're seeing a big upturn in the liability side of the business."

For now, however, development of the market has to wait until Iraq forms a government and the security situation stabilises further. As C3's Mr Werner puts it: "Iraq is in limbo." AKE's Mr Newton adds: "Eventually I would expect other people to enter the market. The (Lloyd's) syndicates can't take on everything. But that's a way off yet."

According to OPIC's Mr Morris, at a recent meeting of the Berne Union, the leading association for PRI export credit insurers worldwide, industry representatives discussed the fact that while there was a lot of interest in investing in the Kurdistan region, which is dramatically safer and perceive to be more business-friendly, there was not much appetite for the rest of Iraq at the moment. "There are a lot of people testing the water," says Mr Morris, "but it is not flowing yet." ■