

Priority financing needs of Iraqi SMEs Report

Strengthening Public Finances and
Financial Markets (FFM) in Iraq

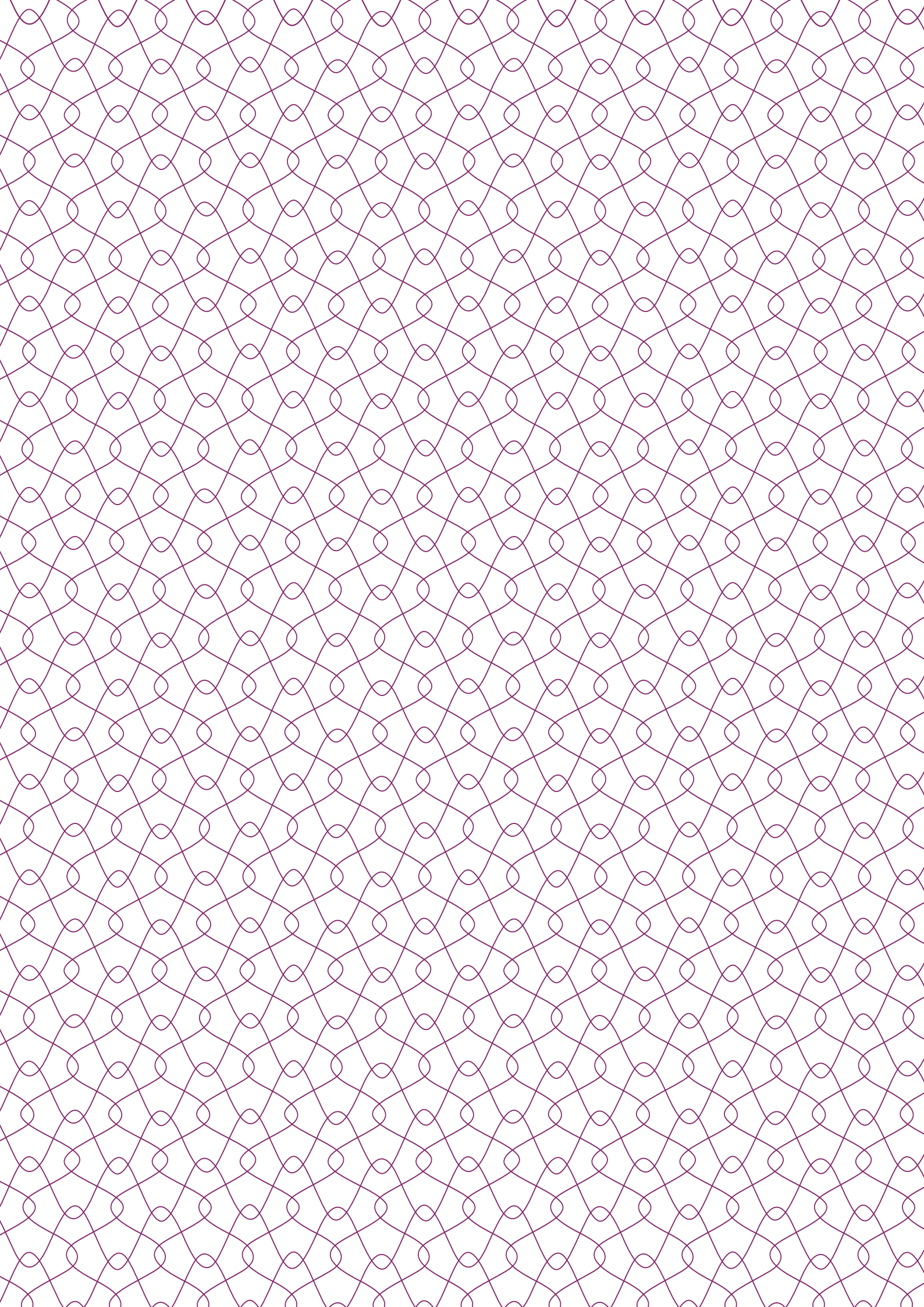


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Report

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Financial Markets (FFM) in Iraq

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Baghdad Office | Baghdad, Iraq

E info@giz.de

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Project

Strengthening Public Finances and Financial
Markets (FFM) in Iraq

Supervision

Dr Antoine Kuruneri-Millet, GIZ

Hussein Al-Mamoori, GIZ

Authored by

Internationale Projekt Consult (IPC) GmbH

Design and layout

Malte Müller, GIZ

Christina Krause, GIZ

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List of abbreviations

BMZ	German Federal Ministry for Economic Cooperation and Development
CBI	Central Bank of Iraq
CIED	Credit Information Exchange Division (CBI)
CSO	Central Statistical Organisation
EU	European Union
FFM	Strengthening Public Finances and Financial Markets in Iraq
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH
ICBG	Iraqi Company for Bank Guarantees
IFC	International Finance Corporation
IFI	Iraqi Federation of Industries
ILO	International Labour Organization
IMF	International Monetary Fund
IPC	Internationale Projekt Consult GmbH
KYC	Know your customer
MENA	Middle East and North Africa
MSMEs	Micro, small and medium-sized enterprises
NPL	Non-performing loan
POS	Point of sale
SMEs	Small and medium-sized enterprises
UNDP	United Nations Development Programme

1 Context

Small and medium-sized enterprises (SMEs) in Iraq are one of the most disadvantaged market segments in terms of access to finance. It is listed by most banks at the bottom of their ranking of financing priorities. Banks in Iraq thrive on making big profits from currency auctions, investing in government debt and financing retail clients. These lucrative alternatives to financing SMEs are made all the more attractive by the challenging economic situation marked by currency instability, weak enforcement of collateral and the stagnant legal situation with regard to proving the property rights of industrial SMEs. All these factors mean that lending to SMEs is not attractive for the banking sector in Iraq.

On the other hand, there have been many market initiatives to strengthen SME access to finance. Topping the list is the One Trillion Dinar Initiative of the Central Bank of Iraq (CBI), which is a refinancing facility aiming to provide cheap funding for SMEs via the banking sector. Other initiatives by international donors and local actors have also helped increase access to credit. However, overall, these measures have done little to fill the financing gap in the market for SME lending in Iraq.

2 Rationale

The international donor community and the Government of Iraq are striving to strengthen sustainable private sector development and economic growth in the country outside the oil and gas sector, support SME development and increase and facilitate SME access to finance in accordance with the latest and most effective international practices in these areas.

However, there has been little research on the specific priority financing needs of Iraqi SMEs, and this limits the ability of the government and the donor community to adjust and tailor their actions and international best practices to the specific circumstances of Iraqi SMEs across the country.

The purpose of this report is to provide an accurate profile of Iraqi SMEs financing habits and field-based facts and figures on their priority financing needs in order to further adjust current and future public policies and international technical assistance aimed at increasing and facilitating SME access to finance.

This report was prepared as part of Component 4 of Strengthening Public Finances and Financial Markets in Iraq (FFM), a project implemented by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH and co-financed by the German Federal Ministry for Economic Cooperation and Development (BMZ) and the European Union (EU). Working in partnership with the Government of Iraq, FFM aims to increase and facilitate the access of Iraqi SMEs to finance through policy reform, operational support to the CBI and capacity building for Iraqi banks and financing institutions in critical areas related to lending to SMEs.

Methodology

This report compiles and synthesises the data and findings of the three extensive surveys conducted by the FFM project across Iraq in 2022 and 2023, with the support of key Iraqi stakeholders. The aim of the surveys was to understand:

- a) the current situation of financial intermediation in Iraq;
- b) the priority financing needs of Iraqi SMEs;
- c) obstacles to financing faced by both banks and SMEs in Iraq.

The studies resulting from the three surveys will be published and released in the following months.

The methodology and sources¹ included extensive desk reviews of past research, current public policies and regulations, questionnaires administered to both SMEs and financial intermediaries in partnership with the CBI, and extensive in-depth interviews and focus group discussions across numerous fields with SME owners and managers and with all stakeholders on the Iraqi financing side (including banks pioneering lending to SMEs in Iraq), with the kind and valuable support of the Iraqi Federation of Industries (IFI) and the Iraqi Private Banks League (IPBL). This report is intended to serve as a practical reference tool for decision-makers. It therefore has a deliberately non-academic structure and focuses on key facts, data and findings for actionable recommendations. More details, comprehensive data, further references, more in-depth academic policy analysis and methodological information will be made available in the three above-mentioned survey and research reports to be publicly released in the following months.

3 Objective

The objective of this report is to enhance the effectiveness and impact of actions aimed at increasing and facilitating access to finance, by formulating actionable recommendations to adjust current and future efforts in this area, mainly based on international best practices, assumptions and empirical knowledge and experience, to the actual specific priority needs of Iraqi SMEs. The report acknowledges the existing non-synthesized empirical knowledge and field experiences. However, the content of this report is meant to substantiate and to structure current and future policy dialogue and policy reforms for SMEs increased and facilitated access to finance in Iraq.

This report presents:

- **a profile of Iraqi SMEs, quantifying their access to credit from the financial sector and estimating their real priority financing needs;**
- **based on the above, concrete actionable operational recommendations aimed at the government, donors, aid implementers, the CBI and Iraqi banks for current and future public policies and technical assistance.**

This is also a valuable tool for substantiating the empirical knowledge of the government, donors, aid implementers and banks with robust figures to enable them to shore up their policies and refine their impact evaluations.

¹ This report compiles figures from four key sources: (1) primary survey data of a significant sample of 257 SME owners and managers across Iraq; (2) primary survey data of a significant sample of Iraqi banks to understand their profile, outreach, resource allocation to SMEs and the factors deterring them from focusing on SME lending; (3) primary data provided by from the CBI Operations Directorate, including figures on lending to SMEs under the One Trillion Dinar Initiative; (4) primary data from direct interviews with banks, including those pioneering lending to SMEs in Iraq.

The report also aims to provide a substantiated operational assessment of obstacles faced by banks when lending to Iraqi SMEs, going beyond the more obvious, albeit true, stumbling blocks, such as applicants' lack of collateral and wariness about SMEs, looking into bank processes as barriers to SME financing and the generation of profits from this activity by banks and putting forward proposals for mutually beneficial solutions for banks and SMEs.

The report touches on deep policy issues that are not within the purview of the CBI, particularly legal and contract enforcement issues, but does not discuss them in any depth as the focus is on actionable measures within the purview of the financial sector.

4 Executive summary

4.1 Summary of key findings

- **According to an estimation based on several sources, there are between 377,000 and 840,000 SMEs in Iraq. Based on our survey, the estimated financing needs of SMEs are between USD 3.77 billion and USD 8.40 billion. Yet, the number of Iraqi SMEs administratively eligible for formal financing, that is, officially registered, presenting proper financial statements, up to date with their taxes,² etc. is significantly small.**
- **For the SMEs surveyed, average financing needs are USD 33,020.** The median amount of financing needed is USD 10,000, reflecting the large number of small and very small businesses in the sector. The average financing amount sought by single-person enterprises is USD 9,000. The average financing amount for enterprises with one to three employees and those with four to thirty employees is very similar at around USD 35,000.
- **Despite the dire need for financing, the banking sector's penetration of the SME market is minimal with less than 18% of SMEs having a bank account and less than 5% having access to credit.** SME owners showed a high level of distrust, confusion and a reluctance to deal with the banking sector. Many of them seem unable to understand the importance of establishing a relationship with the bank as a prerequisite for access to credit.
- **Iraqi banks still consider SMEs to be a high-risk sector compared to other lucrative alternatives with higher profits, such as currency auctions, lending to the government and retail lending.** Examination of the balance sheets of several high-profile banks revealed that net interest income accounts, on average, for 47% of total operating income, and for some banks as little as 7%.

² The Iraqi Tax Authority has only 49 000 SMEs officially registered as tax payers, and only 5 000 enterprises are active tax payers.

- **Iraqi banks have a very limited presence in Iraq’s governorates. Moreover, traditional and digital banking products are not well developed or marketed to SMEs.** A bank in Iraq has, on average, nine branches around the country and five employees responsible for dealing with SMEs. This means that there are few opportunities for contact and weak SME customer service.
- **SME lending under the CBI’s One Trillion Dinar Initiative is practically the only window for lending to SMEs.** The initiative was established as a refinancing scheme to encourage commercial banks to extend low-cost credit to SMEs. By 2022, with over 40 participating banks, the total credit extended under the initiative was IQD 2.7 trillion (approximately USD 2 billion). In theory, total disbursements cover between 9.02% and 20.09% of total market needs.
- **Despite the high number of SMEs benefiting from the CBI’s One Trillion Dinar Initiative, only 16% of the funding actually goes to SMEs. A large percentage is used for lending to large corporates and home lending.** The number of beneficiaries increased significantly to 8,434 in 2021 and to 17,658 in 2022. However, a large percentage of the loans disbursed under the initiative, specifically 62% of the total in 2022, have a contract amount of over IQD 1 billion (approximately USD 700,000). This indicates that the borrowers are large corporates rather than SMEs. In addition, 22% of the initiative’s disbursements in 2022 were for real-estate financing.
- Funds for lending under the Five Trillion Dinar Initiative have mainly been used by the Real Estate Bank and the Real Estate Fund and not for financing SMEs or other enterprises (see graph below). Uptake of the initiative’s funding by the Agricultural Cooperation Bank and the Industrial Bank has been minimal. The Agricultural Cooperation Bank is considered to have too many governance and control weaknesses to be able to utilise the initiative’s funds efficiently, and the Industrial Bank has been very reluctant to use the funds and extend credit to enterprises in the industrial sector. Only 225 SMEs are reported to have been financed by the Industrial Bank under the Five Trillion Dinar Initiative in 2022.
- **In terms of business structure, small enterprises with less than three employees are the predominant type of SMEs.** Most SMEs are concentrated in trade and services, which is a reflection of the country’s dependence on imports. While agriculture contributes only marginally to economic output, the SME sector is second only to government in providing employment. In 2020, there were only 26,435 industrial SMEs in Iraq, 188 of which were medium-sized enterprises. Small industrial enterprises, which typically have less than three employees, were estimated to number around 26,247 in the same year. These enterprises are mainly concentrated in Baghdad, Diyala and Kirkuk.
- **There is significant demand for short-term financing to support the purchase and sales cycles of SMEs.** On the sales side, 55% of surveyed SMEs sell on credit, and one third of these have more than 30% of their sales on credit. On the purchases side, 47.8% of SMEs purchase materials on credit, of which 33% have more than 30% of their purchases on credit. In addition, 22% of surveyed SME owners indicated that they would need credit for the purchase of raw materials, while 24% indicated they would invest in increasing inventory. In terms of investment in long-term assets, 16% of the surveyed SMEs planned to invest in land and real estate, while 25% planned to purchase equipment. The median amounts on credit to finance the purchase of raw materials and inventory were USD 7,500

and USD 15,000 respectively. Vehicle and real-estate financing carries a larger ticket size of around USD 40,000.

- **The lack of Sharia-compliant products is among the top constraints for SMEs in applying for credit.** Many Iraqis, including SME owners, are highly sensitive to the 'charging of interest' as they perceive it as a form of usury. Meanwhile, the banks that are most active in SME lending do not offer any products that cater to such concerns. Some development organisations, such as the International Labour Organization (ILO), have come up with Sharia-compliant approaches to soften SME resistance to applying for credit.
- **The lack of guarantees remains the main obstacle for extending credit to private sector businesses.** The credit guarantee system operated by all banks is almost exclusively based on the use of civil servant salaries as security. Real-estate collateral is secondary to salary-based collateral in virtually all banks. This approach to granting loans creates challenges for businesses which typically rely on business facilities as collateral. Moreover, it limits the financing of Iraqi SMEs to the small number of civil servants willing and able to put up their salary as a guarantee, making private sector financing and development dependent on public sector employment.
- The Iraqi Company for Bank Guarantees (ICBG) is the only established guarantee facility in Iraq that provides banks with guarantees for the loans they grant to enterprises, but the weakness and limitation is that it **only** guarantees loans granted by banks to **enterprises that already have collateral**. This means that, in practice, the ICBG provides guarantees to lending banks while still demanding salary-based guarantees from borrowing enterprises.
- **SME owners generally do not have a high level of education. The vast majority lack basic knowledge of financial management and banking products. Moreover, SME employees usually have little to no education, with the result that Iraqi SMEs are not innovative and are less likely to produce value-added products suitable for export.** The level of education is generally low in small enterprises, and tertiary education is more common in larger ones. Interestingly, business owners in the industrial sector tend to have lower education levels than those who run a trade business. The low level of financial literacy means that SMEs often fail to manage their finances properly, even in relation to simple concepts such as putting money aside to meet future obligations. In addition, most SMEs are not aware what banks offer in terms of credit and non-credit products. The banks themselves are partly responsible for this, due to shortcomings in terms of visibility and marketing campaigns.
- **The presence of women in economic life is generally limited.** There was a clear lack of female representation in the businesses interviewed for this study. Women are seen more in managerial and administrative positions in government and non-governmental bodies in Iraq than in the role of running a business. In 2021, the female labour force participation rate was particularly low at 10.6%, compared to 68% for men.
- **Uncertainty around land ownership and titles due to the legacy of economic planning is very problematic for many SMEs, particularly when it comes to access to finance.** Industrial SMEs are generally established on sites designated as agricultural land. This legacy from the country's past still lingers and prevents SMEs from using the land and the real estate on them as collateral.
- **Iraq has one of the lowest rates of financial inclusion in the region. The survey shows that 95% of very small businesses and 69% of small businesses did not have a bank**

account. Research by the United Nations Development Programme (UNDP) on Kurdistan's SMEs found that only 1.5% of those surveyed had a bank account.

- **The study shows that 86% of surveyed SMEs rely on personal savings and family support, rather than on banks, to finance their businesses.** This can diminish the efficiency of financial management and business development by reducing the leverage SMEs can get from using external funding, which requires sound and structured business plans. SMEs may also adopt a less prudent approach to utilising funds than if they came from a bank, as banks tend to monitor the use of the loans they grant.
- The Trillion Dinars Initiatives by the CBI have proved very successful for SMEs with collaterals and able/ eligible to external formal financing.
- The question is, how banks and the CBI can reach out to these 86% SMEs relying on personal financing and about addressing the various reasons that make them choose or resort to informal financing (absence of registration, absence of banks account, absence of proper accounting, lack of awareness about financing products, absence of adequate financing products and absence of collaterals).
- While it was seen that the IFI played an active role in supporting SMEs in accessing credit from banks, the regional chambers of industry in different Iraqi governorates were not aware of all CBI and other relevant regulations that could affect the ability of SMEs under their purview to apply for credit. Many complained about the lack of communication channels with the CBI to understand new developments in the regulations that could affect SME access to finance.

4.2 Main recommendations

Increasing and facilitating the granting of credit to SMEs in Iraq is indeed very challenging in an economy that is heavily reliant on revenue from oil and gas exports and where banks have more attractive options for making profit than extending credit to private sector businesses. Nonetheless, the margin for improvement is significant if the government, the CBI, Iraqi banks, donors and aid implementers consider the following recommendations in addition to drawing on their own experience when promoting lending to. The banks themselves have substantial opportunities to expand their market share in this segment with more tailored product design. The main recommendations are set out below.

4.2.1 Recommendations to the Government of Iraq

- **The Government of Iraq should consider the creation of a government guarantee fund for SMEs providing guarantees for SMEs without collaterals.** This is best international practice in leading transition and advanced economies, particularly for rich oil and gas countries. This could be achieved by establishing an independent guarantee facility.
- **Weaknesses in property registration and the issue of title deeds, particularly in the case of industrial enterprises, need to be addressed by the Iraqi Government.** The majority of SMEs in the industrial sector cannot offer adequate real-estate collateral because most industrial facilities are built on sites designated by legacy law as agricultural land. Support for improvements in these areas will contribute significantly to increasing access to finance by industrial businesses.
- **On a parallel front, Iraqi policy-makers may need to consider establishing a movable collateral register.** An effective movable collateral register with specific enabling legislation

could be established in a much shorter time than, for example, would be required to conduct a full review of the judicial enforcement environment. This should be prioritised, potentially with the support of international donors.

- **A key factor in creating an environment conducive to business growth is currency stability.** The history of many countries with an unstable currency shows that enterprises become reluctant to expand their businesses and banks shy away from extending credit, particularly over long periods. The Iraqi Government, with the CBI leading the way, needs to continue using monetary policy tools to stabilise the exchange rate of the Iraqi dinar to create an environment that enables businesses and banks to operate more efficiently.
- **An ambitious nationwide plan should be launched to promote official SME registration and raise awareness about the practical benefits of registration for business owners and managers** (access to finance, business credibility regionally and internationally, access to financial and business support from the government and international donors, etc.).
- **There should be an ambitious plan for encouraging enterprises to open bank accounts,** hold formal accounting and for encouraging banks to further develop and advertise financing solutions for SMEs.
- **Selective protectionism must be designed and implemented to protect the products of Iraqi industrial SMEs against unfair competition from improperly taxed cheap foreign imports in the Iraqi market. This would allow Iraqi customers to buy Iraqi products priced on a par with cheap imports and enable Iraqi industrial SMEs to realise their potential.** Industrial SMEs are very labour-intensive and therefore have high potential for creating both skilled and unskilled jobs in the Iraqi economy.

4.2.2 Recommendations to the donor community and aid implementers

Donors and development aid implementers should look at how to support recommendations made to the government, the CBI and Iraqi banks and, in parallel, initiate or continue their support in the following areas:

- **The donor community needs to increase efforts to promote financial education/literacy programmes among SMEs.** The programmes should provide training to develop financial management skills (bookkeeping, financial planning and accruals management) and banking literacy to help SMEs understand banking and the economic business environment. Coordination with chambers of industry and commerce is imperative to ensure that financial literacy training is tailored to the needs of different communities of SMEs.
- **The CBI and the donor community are advised to support banks in operating outside the comfort of the CBI initiative and developing banking products with different specifications, collateral requirements and intended uses.** The absence in the market of products for financing short-term liquidity needs is particularly noteworthy. The products should be designed to accommodate the length of SME cash cycles. For very short-term cash needs, overdraft facilities should be offered. For seasonal financing to cover the purchase of raw materials, working capital loans should be offered.
- **One of the most pressing issues in the Iraqi market is the availability of acceptable collateral/guarantees.** As most employees whose salary is paid by direct deposit are

already borrowers or guarantors, there is an urgent need to establish a guarantee facility to allow the inclusion of creditworthy SMEs with no access to collateral.

- Proactive campaigns should be designed and implemented to encourage SME managers to open bank accounts as this contributes greatly to building a banking history between the bank and the SME, which must exist before credit products can be offered.
- Proactive campaigns should be designed and implemented to encourage SME managers to access formal sources of finance rather than rely on personal networks and foreign exchange offices to raise capital. The campaigns should clarify the benefits of formal sources of finance, including better interest rates, higher financial leverage and expert advice on optimal utilisation of funds.
- Given that the equipment and machinery of the majority of Iraqi SMEs is worth less than USD 15,000 – below the amount of their average financing needs – and does not therefore qualify as credible collateral, leasing and Islamic financing, where the financing institution remains the owner of the equipment to be acquired by the enterprise, are two financing vehicles that have considerable potential for the SME lending market. It is worth noting that Islamic financing is a) structurally more expensive than leasing in terms of monthly payments because they are calculated on the total value of the acquired asset rather than on the total value of the acquired asset minus its resale value at the end of the lease, and b) structurally as complex as a traditional loan in terms of implementation.

4.2.3 Recommendations to the CBI

- **Although the CBI has adopted corrective monetary policy measures to reduce the profit margin for currency auctions, it could consider further restricting these gains to encourage banks to focus on traditional lending as their main source of profit.** The CBI could adopt more interventionist policies to force banks to have a minimum percentage of interest-based profit rather than profit from fees. It could also require banks to have a minimum percentage of their total assets in the form of loans to SMEs. Such measures feature in interventionist policies adopted by central banks in Nepal and Egypt to ensure a more participatory approach by banks in lending to SMEs.
- The CBI could consider introducing supportive policies to enhance the presence of banks in different regions to serve SMEs and also require banks to have a minimum number of employees dedicated to SME lending.
- **The CBI is recommended to revise budget allocations for disbursements under the One Trillion Dinar Initiative and put a stronger focus on lending to SMEs rather than to large corporations and medium-sized enterprises,** given that small enterprises represent just 16% of the beneficiaries of the One Trillion Dinar Initiative and that a large percentage of the initiative's funds is being used for individual real-estate financing which was in line with the ambition to boost the economy but yielded more modest direct financing results for the SME segment.
- **The CBI Credit Information Exchange Division (CIED), that is, the Credit Bureau and Credit Registry, should be used to compensate for the lack of collateral of SMEs by providing them with a credit scoring to help them create a reputational record that will objectivise and reduce credit risk, encourage banks to lend to them and help financing institutions with customer selection and risk management.** In addition, one of the priorities for improvement is to classify SME loans in the CIED database so that the

regulators can constantly monitor the performance of this credit sector for enhanced enterprise financing policies.

- **The CBI could consider establishing a mechanism to periodically monitor SME access to banking services, including credit, and whether they have a traditional or digital bank account.** Monitoring SME access to credit could be established through the Credit Bureau at the CBI by consolidating know-your-customer (KYC) data and determining the percentage of account owners that can be classified as SMEs.
- **The CBI could consider revising the directives on the One Trillion Dinar Initiative to allow a wider variety of collateral options.** The current directives do not include movable assets (particularly vehicles and industrial equipment) as acceptable collateral options. A prerequisite for the success of this initiative is to have a movable collateral register and expert committees to assess the value of assets.
- **The CBI is advised to revise banks' requirements for account opening, particularly in relation to KYC procedures.** Restoring a climate of trust between banks and the private sector, right from the initial step of account opening, is important as the basis for banks to know their customers better, enabling them to be bolder in offering credit. While the KYC process is of great importance in combating money laundering, the procedures involved are regarded as highly tedious and cumbersome for most corporate clients.
- **The CBI should implement a binding regulatory cap on interest rates for SME loans.** Failure to comply with such caps would be considered predatory banking and incur disciplinary action by the CBI.
- The CBI needs to push for greater involvement by Islamic banks in SME lending as the five leading banks in this area are all non-Islamic banks. It should start a dialogue with non-Islamic banks to discuss Sharia-compliant products for SMEs.
- The CBI is recommended to consider creating a credit guarantee scheme and/or a government guarantee fund for SMEs without collateral.
- The CBI is recommended to conduct periodical awareness campaigns with the federations of commerce and industry in order to inform the heads of chambers about new legislative developments. This would enable regional chambers to support SMEs under their purview in understanding new legislation and how it could help them in applying for credit from banks.

4.2.4 Recommendations to Iraqi banks

According to the Organisation for Economic Co-operation and Development (OECD), SMEs are the engine of economic and social growth in the most advanced transition and emerging countries in the world and the most sustainable life force of their economies. In the EU, for instance, **although Germany and northern Italy have large, well-known multinational corporations, they actually rely mainly on a vibrant SME sector which constitutes the bulk of their economy nationally and internationally.**

Banks in transition countries and in the most advanced economies have come to see the potential of SMEs, despite an initial reluctance, and developed communication to reach them, targeted products, internal processes and digital tools and provided training for their SME clients. **This has made financing SMEs not only a profitable activity, but also a very sustainable and lucrative business that fuels their other businesses** (real estate, lending

to larger enterprises, personal financing). Our findings show that there is a potentially profitable SME financing market in Iraq if some proactive steps are taken.

- **It is recommended to link lending to medium-sized enterprises with lending to small businesses through a global value chain lending approach.** Lending to the value chain – that is, to enterprises of various sizes but operating along the same value chain – brings great benefits to all participants in the chain for a particular product. It also guarantees the continuity of working with that product and creates many jobs, some within the chain and others that need to be created to complete the workflow. **Value chains with high potential for financing are those that capitalise on the country’s competitive advantage and are also linked to export at the end of the chain.** High potential industries can be inferred from Figure 1 (p. 26), which shows the key industries that make the majority of Iraq’s non-oil exports. **These include the production of dates, bovine leather and paper, and leather processing.**
- Banks should develop financing products addressed to SME’s needs and tailored to their specifics.
- **Banks need to put a stronger focus on offering short-term financing products that help ease the impact of cash cyclicity for SMEs.** This involves developing revolving credit products, namely overdrafts and working capital loans, that help SME owners manage their cash and inventory cycles. Such action by banks could solve the issue of dual pricing, which suppliers use for credit and cash payment. In addition, this approach helps in verifying that loans are used for the purpose declared by SME clients and is therefore very advantageous for banks.
- **While financing for small enterprises has increased significantly over the past two years, the banking sector needs to strengthen its lending to medium-sized enterprises who have higher potential for making value-added products and exporting to other countries.**
- **Islamic-compliant SME products are essential for many Iraqis, with 90% of surveyed SMEs reporting that the absence of Sharia-compliant products was a major deterrent to applying for a loan.** Commercial non-Islamic banks may therefore need to consider developing Sharia-compliant products and work on promoting them through public awareness campaigns.
- **Iraqi banks need to consider investing in the infrastructure necessary to increase their outreach to SMEs.** While the reality in Iraq is that banks have very small branch networks, reaching SMEs requires a wide geographical presence, which entails having a larger branch network across the country’s different economic regions. Moreover, as SMEs become more tech-savvy, banks need to develop their digital infrastructure to onboard clients and process loan requests.
- Due to the decline in the profitability of currency auctions, banks in Iraq are advised to build a strategic focus on SMEs by planning to increase the share of their SME loan portfolio in total assets, especially in light of the cheap funding available under the CBI’s initiative.
- **Additionally, banks need to increase the number of dedicated SME employees and build their capacities** in order to address the very specific requirements for dealing with this market segment.

- **Banks need to consider revising and optimising their lending processes and procedures to streamline the credit cycle.** This is particularly true for government banks, such as the Industrial Bank, where the loan application process typically takes between six and fifteen months, according to numerous interviewees from SMEs in the industrial sector.

4.3 Complementary critical actions for fully unlocking the potential of the Iraqi SME financing market

Need for a strong Iraqi SME constituency

Iraq does not yet have a strong SME constituency or structured network dedicated to SME financing. Such a dedicated private sector structure or branch of an existing private sector organisation will be critical, for the government, to enable sound policy reforms through policy dialogue and cooperation, for banks, to enable and follow up on the development of sound new financing processes, products and procedures and, for the private sector, to enable SMEs to better identify, voice and discuss their financial needs and engage constructively with the government, the CBI and Iraqi financial intermediaries and with existing general private sector constituencies, such as federations, chambers of commerce and sector associations.

According to international best practices, such a dedicated SME financing constituency or network should be driven by the private sector. It could stem from existing private sector constituencies but should be a fully separate entity (in which existing private sector organisations could be represented) in order to capture and voice the specific circumstances of SMEs in terms of business needs, constraints and opportunities.

It should also include advanced Iraqi start-ups and business accelerators in order to create a lively and mutually beneficial permanent SME financing forum capable of unlocking the full potential of Iraqi SME financing and business development.

Need for strong leasing development in the Iraqi market

Leasing is one of the most specialised and flexible financing tools for SMEs seeking to finance equipment to develop their business. The leasing of equipment by SMEs is driving business development and economic growth in the most vibrant advanced and successful transition and emerging economies. It has also proven to be the most effective tool for restructuring defaulting loans into a win-win solution for both the lender and the borrower.

Although leasing was authorised for banks (2004 and 2015) in Iraq, its development is stalled. This is due to several factors:

- **International best practices show that leasing is best promoted, developed and managed by dedicated specialised leasing companies** (sometimes independent entities that are offshoots of banks) rather than by traditional banks due to the specific characteristics of leasing processes.
- Experience in leasing is also paramount, and a critical factor for success is Iraqi financing institutions partnering with experienced international leasing companies. Unfortunately, leasing operations are currently only authorised for conventional or Islamic banks in Iraq, and Iraqi and foreign specialised leasing companies cannot be licensed by the CBI.

- **Leasing is sometimes confused with Islamic banking.** Since charging interest is prohibited by Islamic law, Islamic banks resort to loan operations that resemble leasing, where the Islamic bank remains the owner of the leased asset or equipment. However, the difference with leasing is that it is much more costly for the enterprise. In leasing operations, the enterprise pays lower monthly instalments because it only pays for the use of the asset (i.e. the total value of the asset minus its resale value at the end of the lease period – one to five years), while in Islamic banking, although the Islamic bank remains the owner of the asset, the monthly instalments paid by the enterprise are based on the total value of the asset, hence the much higher monthly payments, which are often unaffordable for micro, small and medium-sized enterprises (MSMEs). Last but not least, leasing operations offer flexibility, convenience and rapid operations, which is not the case with Islamic lending where the processes are as complex and burdensome as for a traditional loan.

The benefits of leasing must be clearly explained and promoted among Iraqi SMEs because experience has shown that SME owners and managers often mistakenly regard it as just another kind of loan with no clear advantages.

Leasing, with its specific features and comparative advantages, is an opportunity for all Iraqi SMEs seeking to acquire equipment to support the development of their business in a cheap, risk-free and flexible way. It is also an opportunity for Iraqi financial intermediaries to engage in profitable risk-free financing of Iraqi economic growth through dedicated leasing companies. There is therefore a need to develop leasing in line with best international practices.

Need for increased and coordinated donor communication on financial support initiatives for SMEs

The international donor community and development aid implementers have provided a tremendous amount of financing support of various kinds for Iraqi enterprises with a good success rate. However, it benefits a very small number of enterprises – often recently created ones – that are aware of these financing initiatives and well versed in their mechanisms. The majority of Iraqi SME owners and managers, however, remain unaware of the financing initiatives of these donors and aid implementers, leaving a large part of the private sector potential for growth untapped.

Additionally, the multiplication of financing support initiatives makes it difficult for potential beneficiaries to have a clear vision of who is proposing what and how to apply for support from the initiative most relevant to their business. Only the CBI-led Trillion Dinar

Benefits of leasing

Monthly leasing payments are much cheaper for enterprises than monthly credit repayments because instead of being based on the entire value of the asset, they are calculated on the value of the asset during the leasing period (usually three to five years), after which the leasing company or the bank will resell the asset. It is risk free because the leasing company and the bank remain the owner of the asset. It is the most flexible financing tool because its limited duration means that it caters to the fast evolving equipment needs and business development of enterprises (scaling up or down), while the purchase of equipment on credit can leave enterprises stuck with outdated equipment and monthly repayments over 10 or 15 years.

Initiatives have engaged in large-scale education and promotion activities which have contributed greatly to their success.

Communication and large-scale education and promotion activities to raise awareness about financial support initiatives for SMEs should not be just a simple, low-budget support activity; it **should be a comprehensive expert activity supported by ambitious budgets** to ensure that all targeted beneficiaries know about the financing initiatives available.

Last but not least, an extensively promoted Iraqi Joint Portal providing access to all donor financing initiatives for SME owners and managers, business incubators and accelerators, business associations, sector federations, etc. **would enable these financing initiatives**, which have demonstrated their effectiveness, **to benefit more target enterprises**.

5 Profile of the SME sector in Iraq: known and new facts and figures

5.1 Definition of the SME sector in the market

Key observation

As in many other countries, a national definition is not strictly followed by the different stakeholders in the Iraqi market. For instance:

- The Iraqi Ministry of Planning defines SMEs in the market according to the number of employees they have (see Table 1).
- The IFI classifies SMEs based on their invested capital and number of employees by means of a case-by-case assessment conducted by an IFI inspection committee (Table 2).
- The definition of SMEs by Iraqi Financial Institutions varies greatly depending on their type and size and is based on the amount of loans granted to the enterprise (Table 3).

Table 1: Definition of SMEs by the Ministry of Planning

<i>Classification</i>	<i>Criteria</i>
Micro	1 to 3 employees including owner
Small	4 to 9 employees including owner
Medium	10 to 29 employees including owner

Table 2: Definition of SMEs by the IFI

<i>Classification</i>	<i>Criteria</i>
Very small	Capital under IQD 10 million (ca. USD 7,000) and less than 5 employees
Small	Capital under IQD 100 million (ca. USD 70,000) and 5 to 10 employees
Medium	Capital under IQD 1 billion (ca. USD 700,000) and 11 to 49 employees
Large	Capital IQD 1 to 6 billion (ca. USD 700,000 to 4.2 million) and over 50 employees
Very large	Capital over IQD 6 billion (ca. USD 4.2 million) and over 50 employees

Table 3: Definition of SMEs by banks

<i>Bank</i>	<i>Classification</i>	<i>Criteria: Loan disbursed</i>
National Bank of Iraq	Micro	less than USD 7,000
	Small	USD 7,000 to 50,000
	Medium	USD 50,000 to 3,000,000
Ashur Bank	Micro	less than USD 5,000
	Small	USD 5,000 to 25,000
	Medium	USD 25,000 to 100,000

Key recommendation for action

- A clear national definition for SMEs should be adopted by the government based on the recommendations of the Ministry of Finance and the CBI after consultation with business associations, sector associations and financial intermediaries. This will provide a clear picture of the situation of this market segment in Iraq, enable targeted policy reforms and allow for effective sector monitoring and regulation, notably regarding SME financing.

5.2 Estimated number of SMEs

The number of SMEs in Iraq is estimated to be between 377,000 and 840,000. SMEs specialised in trade are the largest category, estimated to number between 152,000 and 337,000. The estimated number of industrial SMEs is between 18,850 and 42,000. Iraq's Central Statistical Organisation (CSO) estimated the number of industrial SMEs to be around 26,435, of which only 181 are medium-sized enterprises.

Table 4: Estimated number of SMEs in the industrial, agricultural and trade sectors

Sector	Number of SMEs – Lower estimate	Number of SMEs – Higher estimate
Trade SMEs	151,684	337,969
Industrial SMEs	18,850	42,000
Agricultural SMEs	37,700	84,000
Others	168,766	811,781
Total	377,000	840,000

Source: CSO in Iraq,³ IFC (2022) and IPC survey for estimate of the number of trade SMEs. The individual estimates do not add up to the total, as they have been estimated independently.

Key observations

- SMEs account for over 90% of private sector employment. Yet, the number of SMEs in the country is markedly lower than in other countries in the Middle East and North Africa (MENA) region. For instance, there are five times more SMEs in Turkey and twice as many in Algeria, countries with comparative population sizes.^{4 5}
- The vast majority of industrial SMEs in Iraq are either very small enterprises or microenterprises, according to the conventional definition of SMEs in terms of business size and number of employees. Meanwhile, the estimated total number of industrial medium-sized enterprises in all of Iraq is just 181, accounting for less than 1% of total industrial SMEs. As medium-sized enterprises usually make a major contribution to exports in developing countries,⁶ it is evident that the weak development of industrial SMEs is a major obstacle to increasing Iraq's non-oil exports.
- The trade sector has the largest share of SMEs, due to Iraq's heavy reliance on imports, followed by the agricultural sector, which is second only to the government in terms of providing employment to the Iraqi population.
- Difficulties faced by agricultural SMEs both upstream and downstream include the lack of land title reform, the distortion of market-based principles with the provision of food baskets, the low productivity of farms which, because of their size, do not benefit from economies of scale, the lack of competitiveness of agricultural products on local markets and the overall lack of rational trade and tariff and customs policies.
- Difficulties faced by SMEs in the trade sector include fluctuation of the dinar's exchange rate, which exposes businesses to foreign exchange losses, and the weak network of trade routes with neighbouring countries.
- Difficulties faced by the industrial sector include low banking and financial management literacy, no title deeds for land on which business facilities are constructed and the lack of appropriate policies to protect infant industries.

³ [Central Statistical Organization of Iraq: Industrial statistics](#) [Arabic]

⁴ [IFC: Market Bite Iraq – Economic Recovery Creates Opportunities to Invest in Small and Medium Businesses](#)

⁵ [IFC: Project Brief National Bank of Iraq](#)

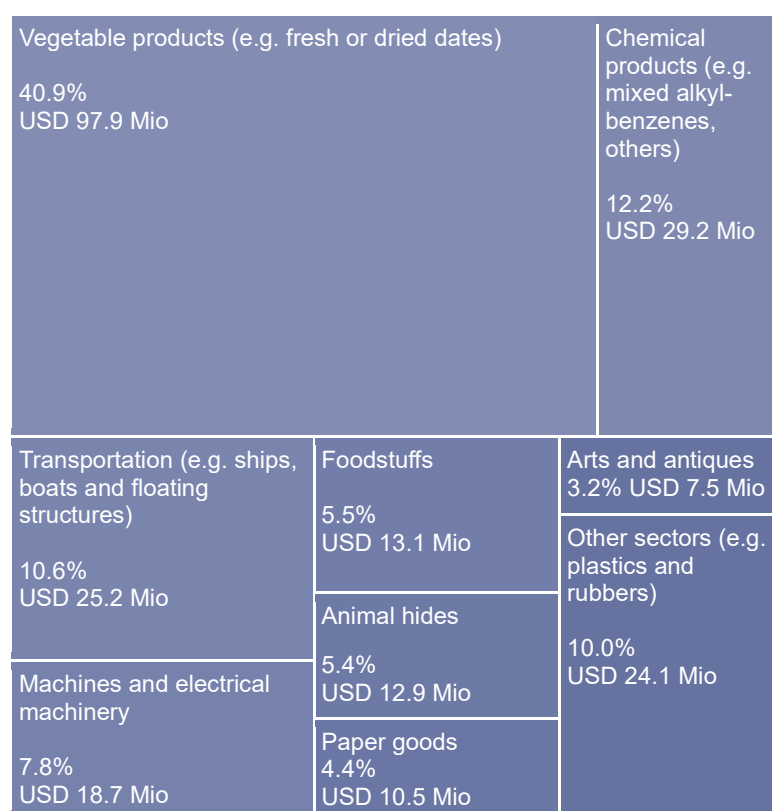
⁶ In Turkey, SMEs are responsible for approximately 39.8% of the country's total exports.

Key recommendations for action

- **An ambitious nationwide plan should be launched to promote official SME registration and raise awareness about the practical benefits of registration for business owners and managers** (access to finance, business credibility regionally and internationally, access to financial and business support from the government and international donors, etc.).
- **The Government of Iraq, particularly the Ministry of Planning and the Ministry of Finance, and the international donor community could consider conducting an in-depth analysis to assess the factors behind the small number of SMEs in value-added industries.** Such an assessment should consider the macroeconomic environment (e.g. the lack of government support programmes, protection for infant industries, etc.) as well as microeconomic factors (lack of competitiveness and technical know-how).

- **Weaknesses in property registration and the issue of title deeds, particularly in the case of industrial and agricultural enterprises, need to be addressed by the Iraqi Government.** The majority of potential clients, particularly in the industrial sector, cannot offer adequate real-estate collateral because most industrial facilities are built on sites designated by legacy law as agricultural land. Support for improvements in these areas will contribute significantly to increasing access to finance by industrial businesses.
- **A key factor in creating an environment conducive to business growth is currency stability.** The history of many countries with an unstable currency shows that enterprises become reluctant to expand their businesses and banks shy away from extending credit, particularly over long periods. The Iraqi Government, with the CBI leading the way, needs to continue using monetary policy tools to stabilise the exchange rate of the Iraqi dinar to create an environment that enables businesses and banks to operate more efficiently.

Figure 1: Iraq's exports in 2020, excluding oil, precious metals and any other metals



The sector area is proportional to the sector share of exports. Exports totaling USD 239 Million.

5.3 SME export capacity

SMEs in Iraq are very weak in terms of international competitiveness and are focused on a very small number of low-value-added products, such as plastic packaging, bottled water, dates and bovine leather.

Due to the marked reliance on imports and the lack of protectionist policies, Iraq's economic policy is particularly hostile towards Iraqi industrial SMEs, despite the fact that they are labour-intensive and can therefore create many jobs. Many of the industrial SMEs interviewed have had to close their factories. The reasons include their inability to compete with imported products (which are low-priced due to the lack of import taxes) and the absence of a government policy protecting Iraqi SME industrial products in the Iraqi market that would enable them to sell at prices comparable to those of cheap foreign imports, which do not create jobs. This prevents Iraqi industrial SMEs from competing in a fair market and from growing their business.

Despite their lack of competitiveness, SMEs are still the main source of private sector employment in Iraq, with 90% of jobs being generated by MSMEs. The job market is characterised by low-skilled labour, with sales workers and craftspeople comprising 44% of total jobs. Government, construction and the retail trade provide the majority of jobs. Over half (54.8%) of all employment is in the informal sector. In agriculture, 98% of jobs are in SMEs, and in the crafts and industrial sector, the share is 88%.

Key observations

- Iraqi SMEs are very weak in terms of value-added activities and business complexity. The employees of most Iraqi SMEs have little to no education. This is due to a confluence of microeconomic and macroeconomic factors:
 - While SME owners and managers tend to have an appropriate level of education, most SME employees have little to no education. This leads to a lack of innovation and reliance on the production of low value-added products.
 - The government does not take the initiative in creating a supportive business environment in which SMEs can flourish, enabling them to meet local market needs before eventually moving into export activities. There are no business clusters that would allow information to be shared among SMEs in the same value chains, and the Iraqi customs authorities are notorious for their cumbersome procedures and lack of transparency.
- A major obstacle to SME development is their lack of access to finance from the banking sector. Industrial and agricultural SMEs, in particular, face serious challenges in securing financing, due to their lack of collateral.

Key recommendations for action

- **Selective protectionism must be designed and implemented by the Iraqi Government to protect the products of the country's industrial SMEs against unfair competition from improperly taxed cheap foreign imports in the Iraqi market. This would allow Iraqi customers to buy Iraqi products priced on a par with cheap imports and enable Iraqi industrial SMEs to realise their potential.** Industrial SMEs are very labour-intensive and therefore have high potential for creating both skilled and unskilled jobs in the Iraqi economy.
- The Iraqi Government and international donors could support training and skills development programmes that would enable SMEs to compete internationally.

- The international donor community could foster a culture of entrepreneurship by promoting entrepreneurship education, providing business mentorship and training programmes and creating a supportive ecosystem that encourages risk-taking and innovation.
- The international donor community could support SMEs in building an innovative mindset by developing industry clusters or national SME constituencies. These would provide SMEs with access to shared resources, such as infrastructure, technology and talent, which would help them become more competitive. Governments can support the development of industry clusters by providing funding, infrastructure and policy support.

6 Profile and situation of credit offerings for SMEs in Iraq

6.1 Landscape of the Iraqi banking sector

At the time of writing, there were 78 banks operating in Iraq.⁷

Table 5: Distribution of Iraqi banks by type

	<i>Islamic banks</i>	<i>Private banks</i>	<i>Specialised government banks</i>	<i>Subsidiaries of foreign banks</i>	<i>Subsidiaries of foreign Islamic banks</i>	<i>Representative bank offices</i>
<i>Public banks</i>	1		6			
<i>Private banks</i>	10	25		16	2	2
<i>Private banks - former foreign exchange offices</i>	18					

Key observations

- Al-Rafidain and Rasheed (both public banks) dominate the sector in terms of asset size, with the two banks accounting for more than 70% of the sector's aggregated balance sheet.
- The banking sector has the highest interest rate spread in the MENA region, at about seven percentage points, implying high funding costs for the private sector (IMF 2019). Such spreads have caused significant exclusion of SMEs before the CBI took action with its initiative.

⁷ [CBI: Overview of Banks in Iraq](#) [Arabic]

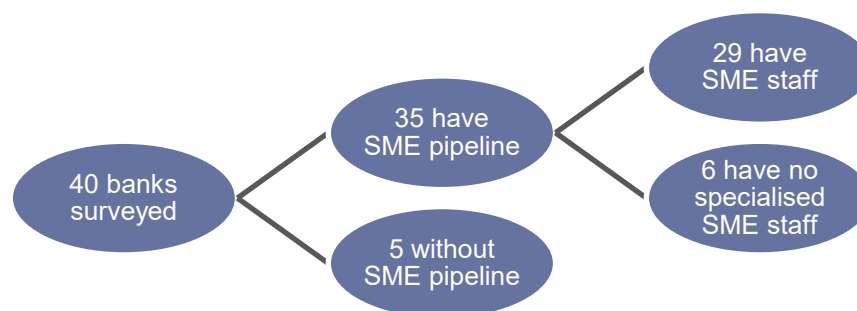
- Banks in Iraq make considerable profits from currency auctions held by the CBI. This entails purchasing foreign exchange from the CBI and reselling it to the private sector at a substantial mark-up. This was, by and large, the main reason for their disinclination to engage in traditional lending to the private sector.
- Although foreign exchange spreads have narrowed in recent years, they remain a key source of profitability for banks. As explained below, the net interest income from loans is relatively low for some banks.

Key recommendations for action

- Due to the decline in the profitability of currency auctions, banks in Iraq are advised to build a strategic focus on SMEs by planning to increase the share of their SME loan portfolio in total assets, especially in light of the cheap funding available under the CBI's initiative.
- **Although the CBI has adopted corrective monetary policy measures to reduce the profit margin for currency auctions, it could consider further restricting these gains to encourage banks to focus on traditional lending as their main source of profit.** The CBI could adopt more interventionist policies to force banks to have a minimum percentage of interest-based profit rather than profit from fees. It could also require banks to have a minimum percentage of their total assets in the form of loans to SMEs. Such measures feature in interventionist policies adopted by central banks in Nepal and Egypt to ensure a more participatory approach by banks in lending to SMEs.
- **The CBI could consider establishing a mechanism to periodically monitor SME access to banking services, including credit, and whether they have a traditional or digital bank account.** Monitoring SME access to credit could be established through the Credit Bureau at the CBI by consolidating KYC data and determining the percentage of account owners that can be classified as SMEs.

6.2 Level of openness to SME lending

Figure 2: Bank operational/staff capacity to service SMEs



Key observations

- Banks in Iraq have a very small branch network in relation to the size of the country. The average number of branches for private banks is nine, while pioneering SME lenders have between 15 and 19 branches.

- 29 out of the 40 banks surveyed reported that they have specialised SME staff. However, the average number of SME staff in private banks is around five, with leading banks in SME lending having between 12 and 25 SME staff members.
- **Overall, it is quite evident that there is a major problem of understaffing in banks for SME lending. This is also due to the small branch network which is not conducive to reaching SMEs located outside city centres.**

Key recommendations for action

- Banks need to increase the number of dedicated SME employees and build their capacities in order to address the very specific requirements for dealing with this market segment.
- Iraqi banks need to consider investing in the infrastructure necessary to increase their outreach to SMEs. While the reality in Iraq is that banks have very small branch networks, reaching SMEs requires a wide geographical presence and larger branch network across the country's economic regions. Moreover, as SMEs become more tech-savvy, banks need to develop their digital infrastructure to onboard clients and process loan requests.
- The CBI could consider supportive policies to enhance presence of banks in different regions and also require banks to have a minimum number of employees dedicated to SME lending.

6.3 Credit offerings for SMEs under CBI initiatives

Given the reluctance of the financial sector to extend credit to SMEs, the Iraqi Government has taken a major step in improving access to credit for SMEs by creating two refinancing facilities.

One Trillion Dinar Initiative

The One Trillion Dinar Initiative in Iraq is a government programme that was announced in June 2015 with the aim of creating job opportunities and boosting the country's economic growth through SMEs. The programme is intended to provide loans to SMEs to help them grow and create jobs. Under the initiative, the government aimed to distribute 1 trillion Iraqi dinars (roughly equivalent to USD 800 million) in the form of loans to eligible SMEs, with a focus on businesses that are involved in manufacturing, agriculture and other sectors with high growth potential.

The loans are granted to banks at a low interest rate (around 0.5% refinancing rate) and are intended to be used for investment in equipment, facilities and other resources that will help SMEs expand and create jobs. By the end of 2019, the initiative had managed to promote lending to 3,235 SMEs, with a total cumulative volume of IQD 98 billion.⁸ **By 2022, the number of beneficiaries had increased to 17,658, with a cumulative disbursement of around IQD 2.7 trillion. While these figures reflect significant progress, the section below shows that the majority of the disbursements are not specifically targeting SMEs.**

One of the controversial steps taken to increase the uptake of the initiative's funds was to raise the ceiling on housing finance in August 2020 from IQD 75 million to 100 million. This move raised concerns that the funds were not being optimally channelled to SMEs.

Nonetheless, the One Trillion Dinar Initiative is a very important step in providing local banks with a refinancing facility with very competitive rates to reduce the cost of financing.

⁸ [CBI: Announcement on the One Trillion Dinar Initiative](#) [Arabic]

Five Trillion Dinar Initiative

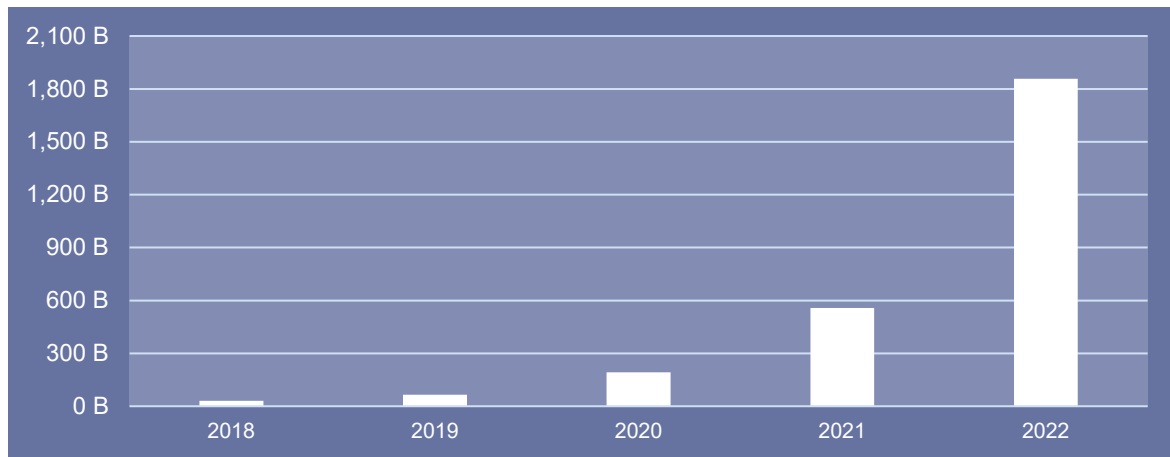
The Five Trillion Dinar Initiative is a companion to the One Trillion Dinar Initiative and was announced at the same time in 2015. The difference between the two is the channel used and the customers targeted. The Five Trillion Dinar Initiative is aimed at financing large projects **through public banks only**. The initiative's main success was in housing and construction loans, while amounts for disbursement via the public Industrial Bank and Agricultural Cooperation Bank were minimal. This was due to inefficiencies in these two banks, which can be attributed to a lack of technical knowledge and appropriate infrastructure.⁹

6.3.1 Lending under the One Trillion Dinar Initiative

Key observations

- The total cumulative disbursements made under the One Trillion Dinar Initiative reached IQD 2.7 trillion (USD 2.08 billion) by the end of 2022. Around IQD 1.8 trillion (approximately USD 1.43 billion) was disbursed under the initiative in 2022 compared to IQD 0.5 trillion (around USD 0.43 billion) by the end of 2021, a significant increase of 233%.

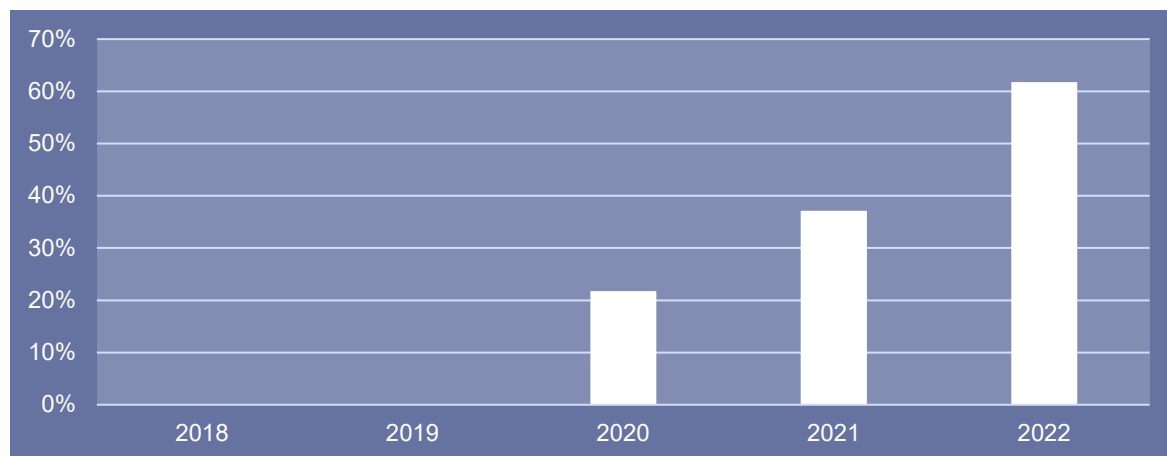
Figure 3: Loans disbursed in IQD – One Trillion Dinar Initiative



- A large percentage of the loans disbursed under the initiative, 62% of the total disbursed in 2022, have a contract amount of more than IQD 1 billion (approximately USD 700,000). These borrowers cannot be classified as SMEs and are mostly very large corporations. A large percentage of the initiative's resources does not therefore benefit SME clients.

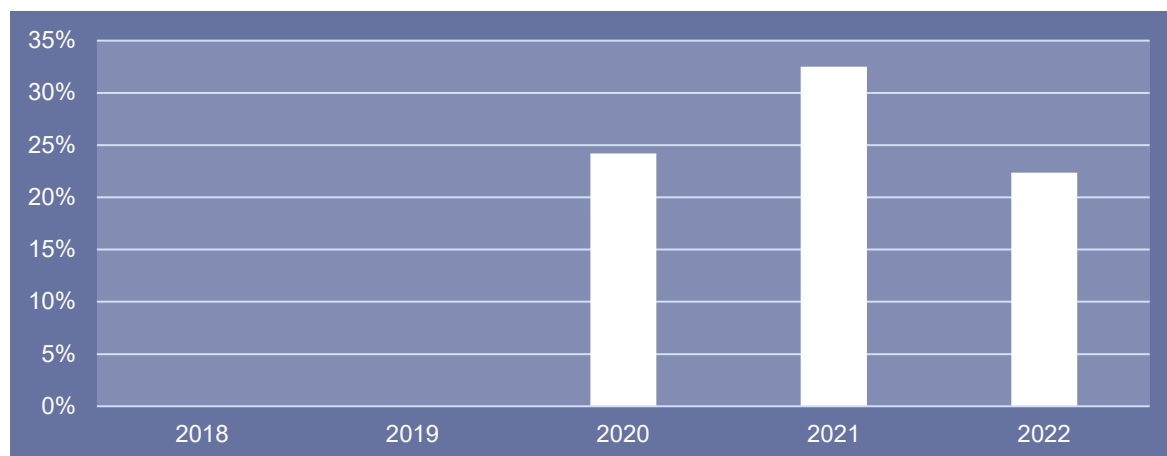
⁹ [Al-Furat Centre for Development and Strategic Studies: The central bank initiative and economic performance \[Arabic\]](#)

Figure 4: Percentage of loans disbursed with a contract amount over IQD 1 billion



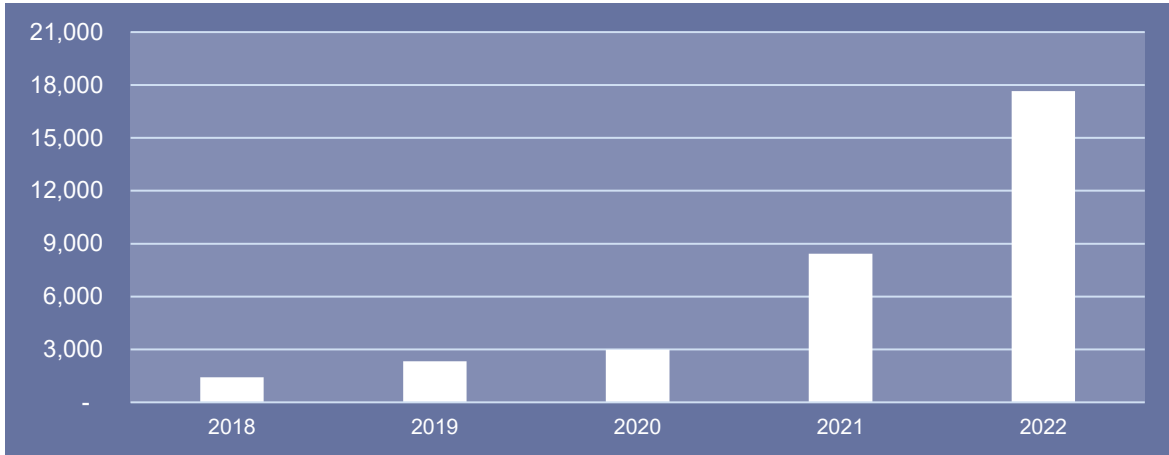
- In addition, 22% of the initiative’s disbursements in 2022 were for real-estate financing. These loans, together with those granted to large corporates, accounted for 84% of the funds disbursed under the initiative in 2022. **It can therefore be inferred that only 16% of the initiative’s funding goes to manufacturing and service-oriented SMEs.**

Figure 5: Loans disbursed for real-estate financing (percentage)



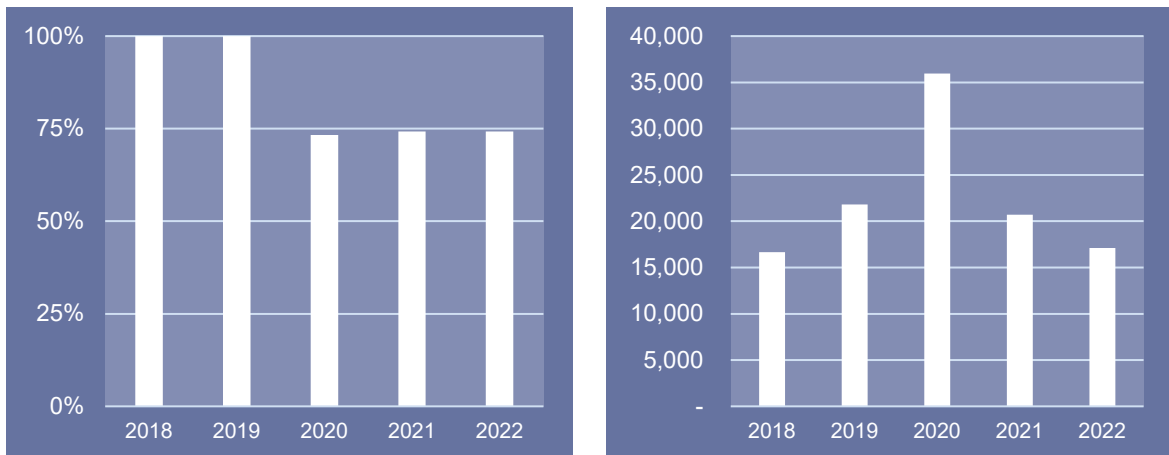
- The number of beneficiaries increased significantly from 2,982 in 2020 to 8,434 in 2021 and 17,658 in 2022.

Figure 6: Number of beneficiaries – One Trillion Dinar Initiative



- Unlike the distribution of the initiative’s funding by disbursement amounts, the number of SME beneficiaries is quite high compared to corporate clients. This is only to be expected as the loan amounts are smaller than those granted to corporates and spread across a larger number of SMEs. The average loan size for SME beneficiaries ranges from around IQD 21.5 million (approximately USD 16,000) to around IQD 46 million (approximately USD 36,000). The amount requested by most SMEs is estimated at USD 33,000, according to the data collected in the SME surveys, and therefore falls within this range. The figures suggest that most of the beneficiaries are small or very small businesses rather than medium-sized enterprises. This coincides with input from discussions held with several banks pioneering SME lending, which revealed that the average loan amount for SMEs is generally in the region of USD 20,000.

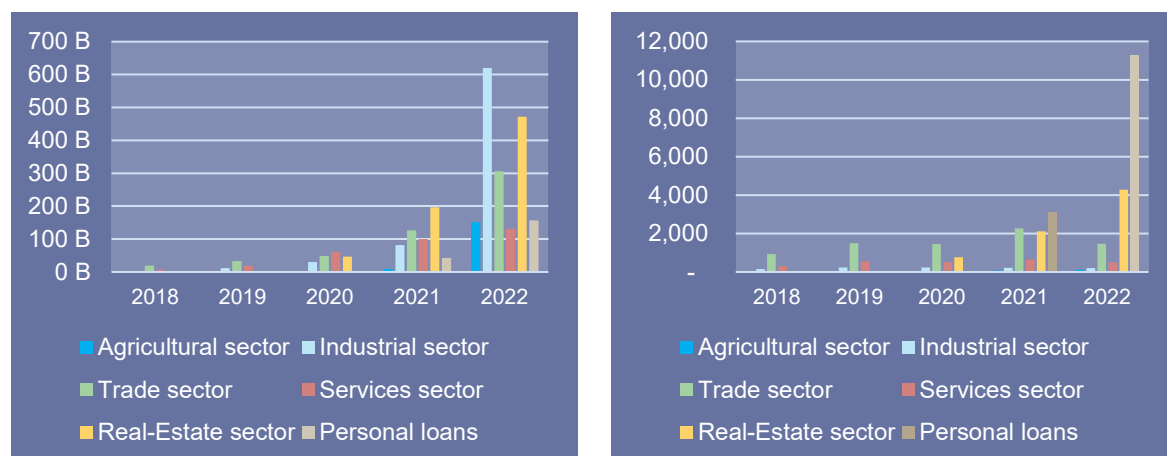
Figure 7: Estimated percentage of SME beneficiaries (left) and average loan size for SME beneficiaries in USD (right)



The sectoral distribution of the loan portfolio funded by the One Trillion Dinar Initiative shows that the largest categories are businesses in the trade, industrial and construction sectors. When cross-checking this information with findings from Figure 4, it can be concluded that the industrial and trade businesses financed under the initiative are, for the most part, a relatively small number of large corporate clients. A look at the sectoral distribution of the initiative’s

portfolio by number of beneficiaries confirms this – the number of beneficiaries in the industrial sector is negligible.

Figure 8: Sectoral distribution of disbursements by amount (left) and by beneficiary category (right)



Key recommendations for action

- While the number of small enterprises benefiting from the initiative has increased significantly over the past two years, the banking sector needs to put a stronger focus on increasing the number of medium-sized beneficiaries.
- **The CBI is recommended to revise budget allocations for disbursements under the One Trillion Dinar Initiative and put a stronger focus on lending to SMEs rather than to large corporations and to borrowers intending to finance real-estate purchases.**
- The lack of loan guarantees remains a tricky challenge for SMEs, hindering their access to credit in a very risk-averse banking environment. There is an urgent need for international organisations to establish a guarantee facility to allow the inclusion of creditworthy SMEs with no access to collateral. The success of the financial inclusion initiative implemented with the ILO, which targeted very small businesses, can be largely attributed to the fact that banks were encouraged to lend to them through secured loans under a meticulously designed intervention programme.
- Despite the high number of very small enterprises benefiting from the initiative's funding, compared to larger businesses, **the vast majority of such enterprises are still excluded from financial services as banks generally create entry barriers for such customers (requiring a referee to open an account, guarantors, collateral, etc.). The donor community can play a supportive role in onboarding such businesses into the formal financial sector**, by creating specialised programmes that give financial and capacity building support to them and act as the referee so that they can gain access to the formal banking sector.
- **Most of these businesses are classified as being in the informal sector and do not formalise their activities due to the high cost of commercial registration fees and taxes. International organisations could hold educational seminars**, in cooperation with the Ministry of Commerce (Department of Companies Registration) and the Ministry of Finance (Tax Department), **to explain the obligation and the benefits for the enterprise**

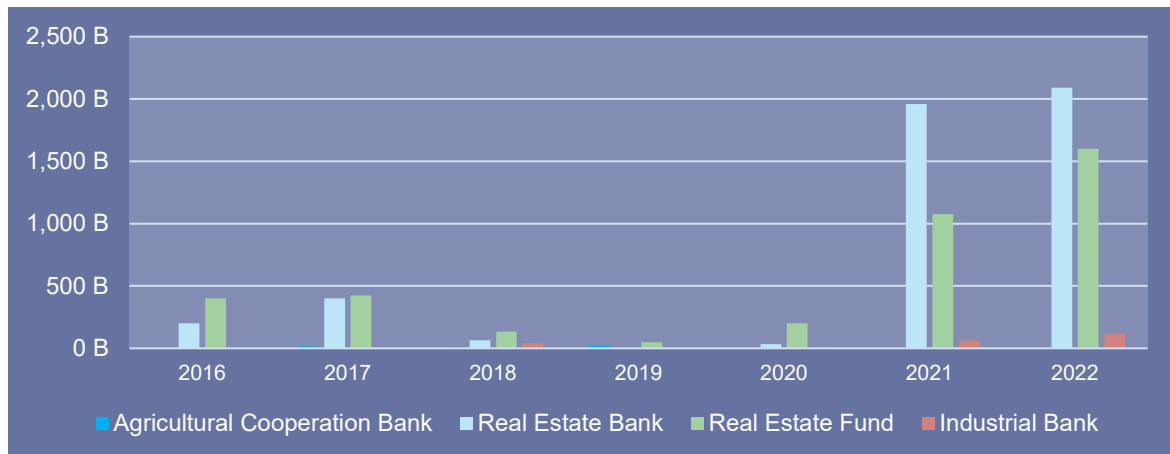
to enter the organised labour market. Simple and practical procedures and affordable fees should also be established to encourage these businesses to join the formal labour market.

6.3.2 Lending under the Five Trillion Dinar Initiative

Key observations

- Funds for lending under the Five Trillion Dinar Initiative have mainly been used by the Real Estate Bank and the Real Estate Fund and not for financing SMEs or other enterprises (see graph below). Uptake of the initiative's funding by the Agricultural Cooperation Bank and the Industrial Bank has been minimal. The Agricultural Cooperation Bank is considered to have too many governance and control weaknesses to be able to utilise the initiative's funds efficiently, and the Industrial Bank has been very reluctant to use the funds and extend credit to enterprises in the industrial sector. Only 225 SMEs are reported to have been financed by the Industrial Bank under the Five Trillion Dinar Initiative in 2022.

Figure 9: Loans disbursed in IQD – Five Trillion Dinar Initiative

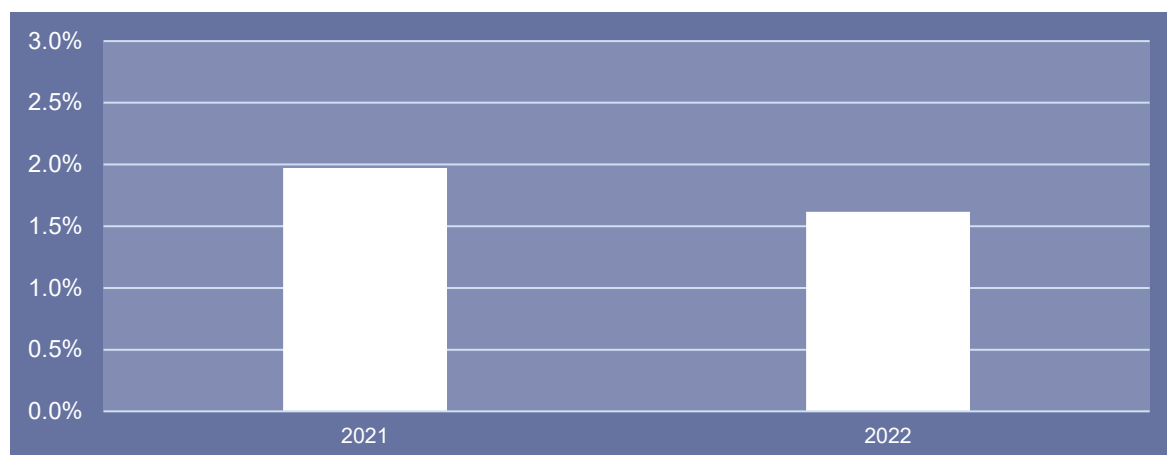


6.4 Non-performing loans (NPLs)

Key observations

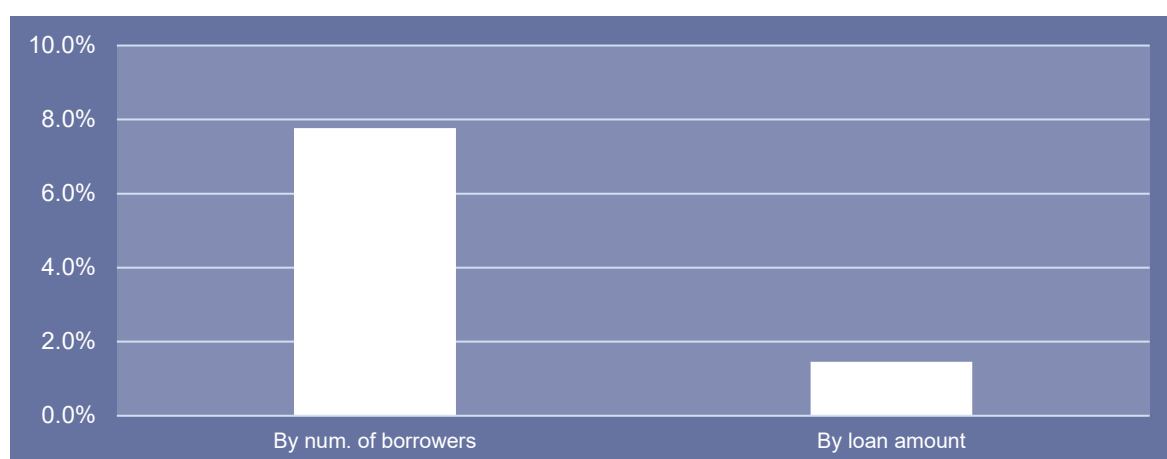
- Banks generally argue that SME lending is risky, with potential losses from the high percentage of NPLs. **Examination of SME portfolio data from a sample of banks indicated that NPLs accounted for 1.6% of total SME loans in 2022 compared to 2% in 2021.**

Figure 10: Percentage of NPLs



- The data received from the ICBG shows that 1.5% of the total amount of loans guaranteed by the ICBG was reimbursed as a result of the decline in portfolio quality due to defaults.

Figure 11: Reimbursements on loan impairment by the ICBG (percentage)



- Banks pioneering SME lending indicated that their entire SME portfolio was guaranteed by the ICBG. However, the mechanism used by the **ICBG has come under criticism as it requires the same guarantees as any other bank**. Both banks and SMEs repeatedly called for a credit guarantee mechanism to be established, given the limitations of the ICBG.

Key recommendation for action

- **A credit guarantee scheme could be established to address the limitations of the ICBG and enable SMEs with no or non-traditional collateral to access financing from banks.**

6.5 Competitiveness of SME lending rates

Key observation

- The CBI dictates that the lending rates for SMEs under the initiative should be 2.9% for loans under IQD 20 million and 3.4% for loans over this amount. Meanwhile, in the survey, Iraqi banks reported that their SME lending rate was around 6.8%. High interest rates applied by

Iraqi banks outside the Trillion Dinar Initiatives mean that loans are not attractive or affordable to most SMEs.

Figure 12: Lending rates at sampled banks



Key recommendation for action

- The CBI should implement a binding regulatory cap on interest rates for SME loans. Failure to comply with such caps would be considered predatory banking and incur disciplinary action by the CBI.

6.6 Existing credit guarantee schemes and products

Key observations

- At present, in 2023, the ICBG is the only established credit guarantee facility in Iraq. It was set up in March 2006 as a limited liability company, owned by 11 private banks with licences from the CBI, and later received a support grant of USD 5 million from USAID.
- The ICBG provides participating banks with guarantees of up to 75% of the amount borrowed by an enterprise. Its main objective is to enhance access to credit by eligible Iraqi SMEs.
- The ICBG has faced certain challenges in recent years, including complaints from a number of banks about its lack of transparency and accountability and concerns about the quality of its guarantee products, which have been addressed by the Iraqi Government.
- However, **the ICBG’s main weakness and limitation is that it only issues guarantees to borrowers who already have conventional collateral.**

Table 6: ICBG performance since inception

<i>Number of loans disbursed</i>	<i>Amount disbursed (IQD)</i>
17,860	329,257,761,000

Key recommendation for action

- **Overall, the ICBG remains an important institution in the Iraqi financial system, providing critical support to SMEs and helping to drive economic growth and development in**

the country. **However, the fact that the current ICBG procedures require the provision by the SME of a conventional - e.g. salary-based - guarantee in order to guarantee bank loans raises key questions over its additionality effect. It is a matter of urgency for the Iraqi Government, in coordination with international donors, to lower the collateral/guarantee barrier hindering access to finance for SMEs. This could be done by establishing an independent credit guarantee facility for SMEs without collaterals.**

6.7 Obstacles to lending to SMEs – the bank’s perspective

The surveyed banks expressed their opinion on a number of salient issues in the credit market and rated them as shown in the following graph in terms of their impact on their ability to extend credit to SMEs.

Figure 13: Obstacles to lending to SMEs – the bank’s perspective



Key observation: *Fluctuations in the exchange rate of the Iraqi dinar*

- Currency auctions enabled Iraqi banks to make very good profits by purchasing foreign exchange from the CBI and then selling it to the private sector at a substantial mark-up. This distracts and discourages Iraqi banks from lending to SMEs and other enterprises. However,

foreign exchange spreads have narrowed over the past year, and the profitability of such transactions has fallen sharply, providing an opportunity for public policies to boost financing for businesses.

- The depreciation of the Iraqi dinar against hard currencies negatively affects the banks' appetite to lend to SMEs in two important ways: first, the banks become wary about lending to the private sector for long periods to avoid suffering financial losses due to currency devaluations during the lifetime of the loan; second, currency depreciation makes it more expensive for banks to obtain foreign currency funding due to the cost of borrowing and hedging. This results in higher interest rates on loans to the private sector, including SMEs.
- In addition, SMEs that rely heavily on imports for their operations bear higher costs when the dinar falls. This affects their profitability and consequently their ability to repay loans.

Key observation: Unreliable financial statements by SMEs and incomplete formal registration

- SMEs often provide incorrect and/or incomplete data to banks on their financial and business situation, which makes it difficult for banks to accurately assess their risk and creditworthiness. This problem is further compounded by the lack of a central bank credit bureau with a comprehensive credit reporting and scoring system for enterprises in Iraq.

Key observation: Difficulty in securing a court decision and enforcing judgments

- The fact that there are no specialised commercial courts able to make informed legal decisions and no clear and effective procedures for the enforcement of court judgments means that legal actions against defaulting borrowers are very tedious and time-consuming for banks.

“It is very difficult to get a court judgment against a defaulter because courts often sympathise with the borrowers.”
— quote from the bank survey

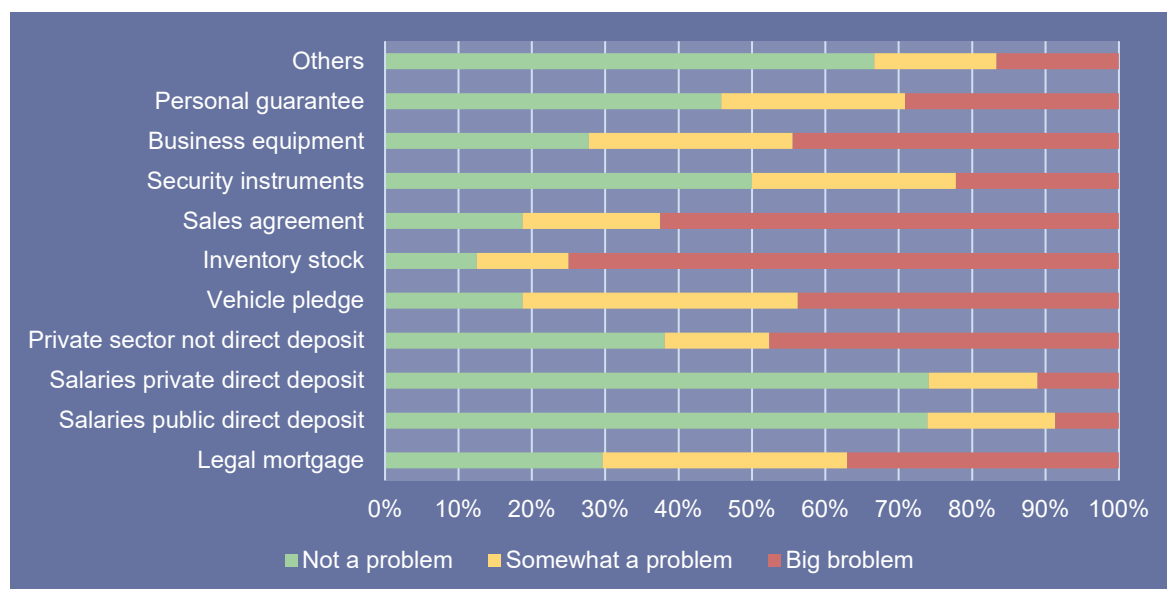
- Courts fail to enforce the seizure of property put up as collateral for countless reasons related to corruption and the difficulty of taking possession of real estate in areas where tribalism is dominant.
- In the rare cases where vehicles are placed as collateral, banks face great challenges when dealing with the public transportation authorities to locate and seize the vehicles.
- The legal procedures for auctioning seized collateral are lengthy, often dragging on for more than a year after the asset was seized.
- These obstacles increase enforcement costs for financial institutions unnecessarily, likely resulting in a tightening of credit conditions and a contraction of the credit supply.

Key observation: Lack of trusted guarantees/collateral

- The banks' distrust in the legal system contributes greatly to their preference for salaries paid by direct deposit as a hassle-free, accepted guarantee for a loan.

- While most banks accept real estate as collateral, it is generally regarded as highly problematic due to delays in property confiscation and liquidation. The percentage of real-estate collateral is therefore relatively low at most banks, anecdotally accounting for less than 30% of total SME collateral.

Figure 14: Collateral enforceability from the bank’s perspective



Key observation: SME failure to meet legal and regulatory requirements

- SMEs are often not fully registered or not registered at all due to cumbersome registration processes, and this prevents banks from lending to them. Interviews with heads of chambers of industry reported that it is necessary to obtain 14 administrative approvals from different government bodies to be fully registered. Banks refuse to grant personal loans to SME owners or managers, limiting the financing options available. Consequently, the amount of the loan, if granted, will not be enough to enable the SME to realise its potential and implement its business plan and will therefore fail to meet the enterprise’s financing needs.

Key recommendations for action

- A key factor in creating an environment conducive to business growth is currency stability. The history of many countries with an unstable currency shows that enterprises become reluctant to expand their businesses and banks shy away from extending credit, particularly over long periods. The Iraqi Government, with the CBI leading the way, needs to continue using monetary policy tools to stabilise the exchange rate of the Iraqi dinar to create an environment that enables businesses and banks to operate more efficiently.
- The donor community needs to increase efforts to promote financial education/literacy programmes among SMEs. The programmes should provide training to develop financial management skills (bookkeeping, financial planning and accruals management) and banking literacy to help SMEs understand banking and the economic business environment. Coordination with chambers of industry and commerce is imperative to ensure that financial literacy training is tailored to the needs of different communities of SMEs.

- Weaknesses in property registration and the issue of title deeds, particularly in the case of industrial enterprises, need to be addressed by the Iraqi Government. On a parallel front, Iraqi policy-makers may need to consider establishing a movable collateral register. An effective movable collateral register with specific enabling legislation could be established in a much shorter time than would be required, for example, to conduct a full review of the judicial enforcement environment. This should be prioritised, potentially with the support of international donors.
- An ambitious nationwide plan should be launched to promote official SME registration and raise awareness about the practical benefits of registration for business owners and managers (access to finance, business credibility regionally and internationally, access to financial and business support from the government and international donors, etc.).

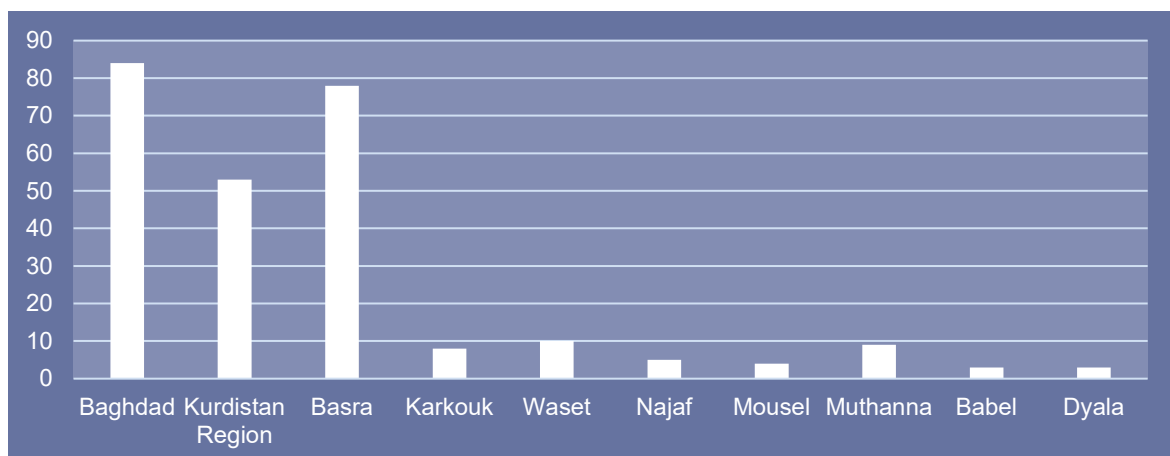
7 SME financing profile and priority financing needs

This section provides an analysis of the characteristics, preferences and business specifications of Iraqi SMEs, based on a representative sample of 257 enterprises.¹⁰

7.1 Geographical distribution

The following table shows the distribution of the sample by governorate.

Figure 15: Distribution of sampled SMEs by geographical location



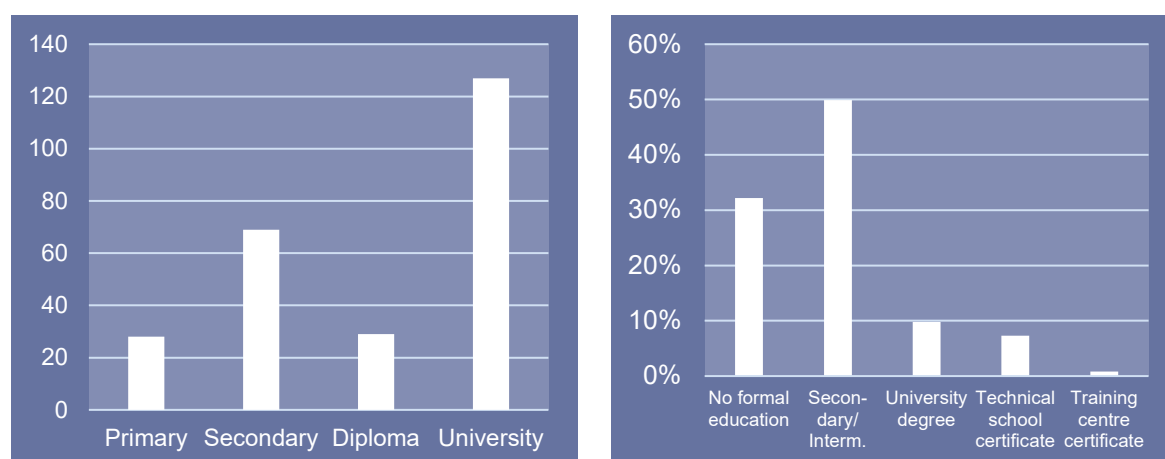
¹⁰ The survey was administered in several Iraqi governorates by a field survey team, with support from the IFI.

7.2 Profile of SME owners/managers (gender, education and experience)

Key observations

- The profile of SME owners varies greatly depending on the size of the business and the economic sector.
- Overall, 50% of SME owners/managers have a university degree, and 60% have some form of tertiary education (diploma or university). Generally, the larger the business is in terms of total equipment value, the more likely the owner/manager is to have a university degree.
- A 2022 survey by USAID in the Kurdistan Region showed a more concerning picture, with just 10% of the sample of SME owners/managers possessing a university degree. However, it should be noted that this USAID survey focused mainly on microenterprises.

Figure 16: SMEs by education level (left) and for the Kurdistan Region (right)



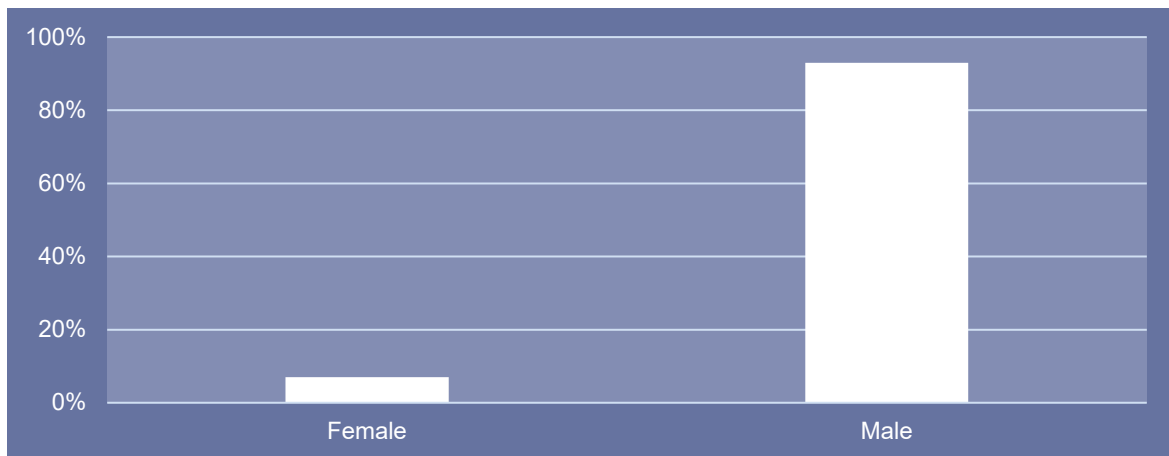
Source: left figure: IPC; right figure: USAID (2022) survey on Kurdistan

- According to a UNDP survey (2021),¹¹ only 20% of SME employees have some sort of tertiary education, and 16% have university degrees.
- Women are greatly underrepresented in the Iraqi entrepreneurial environment, with only 7% of the surveyed SME owners and managers being female. In 2021, the overall female labour force participation rate was particularly low at 10.6%,¹² compared to 68% for men.

¹¹ [UNDP: Iraq MSME Survey 2020](#)

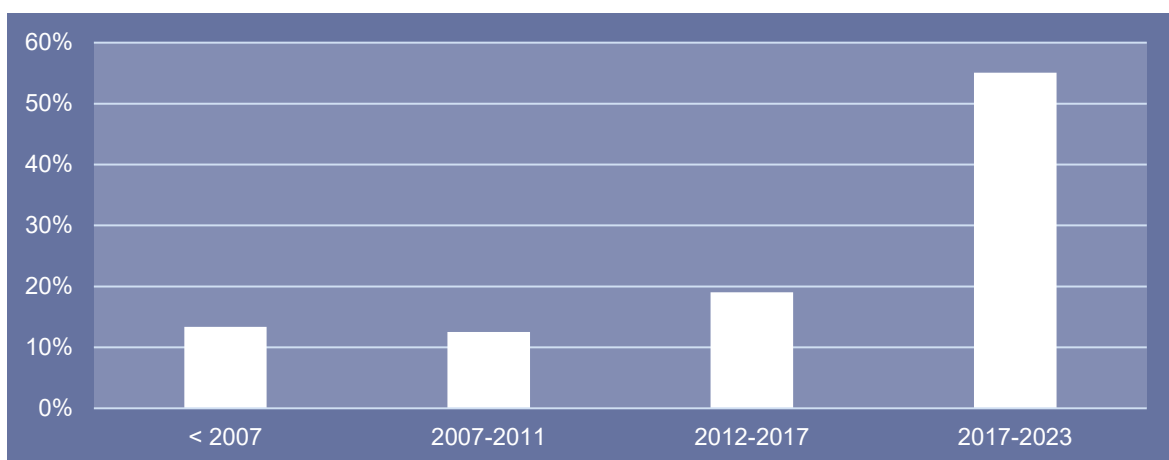
¹² When employed, rather than being involved in running a business, the main roles held by women in Iraq are in managerial and administrative positions in government and non-governmental bodies.

Figure 17: SME owners/managers by gender



- 55% of SMEs, most of them very small businesses, were established after 2017. The life cycle of a business in Iraq is very short as most enterprises close within five years of opening, according to an International Finance Corporation (IFC) report, due to the hostile economic and political environment.¹³ One of the main reasons they fail is that they cannot compete with imported goods which are typically cheaper to produce.

Figure 18: SME distribution by year of establishment



Key recommendations for action

- The fact that a significant number of Iraqi SME owners and managers have a university education is a great advantage when it comes to educating them in finance and in how to prepare professional, objective and well-reasoned loan applications for financial intermediaries.
- A differentiated credit education approach should nevertheless be implemented in order to take into account the lower level of education of microenterprise owners and managers compared to SME owners and managers.

¹³ [IFC: IFC Supports Small and Medium Enterprises in Iraq \(press release\)](#)

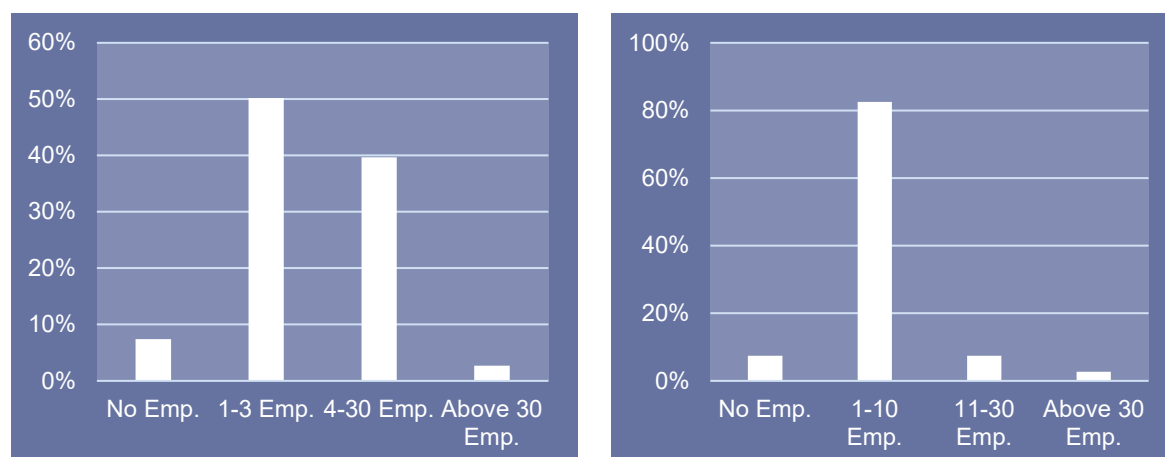
- Iraq’s open-border policy and the lack of control of imports has driven many SMEs to bankruptcy within the first five years of operation. Selective protectionism must be designed and implemented to protect the products of Iraqi industrial SMEs against unfair competition from improperly taxed cheap foreign imports in the Iraqi market. This would allow Iraqi customers to buy Iraqi products priced on a par with cheap imports and enable Iraqi industrial SMEs to realise their potential. Industrial SMEs are very labour-intensive and therefore have high potential for creating both skilled and unskilled jobs in the Iraqi economy.
- The development of specialised leasing companies (Islamic financing does not have the advantage of being economical for enterprises) is important as international experience and best practices show that, if leasing is to be successful and drive economic growth, it is better to entrust it to specialised leasing companies rather than to traditional banks unless they set up separate, independent entities devoted exclusively to corporate leasing.

7.3 SME business profile (employees, branches, sector and assets)

Key observations

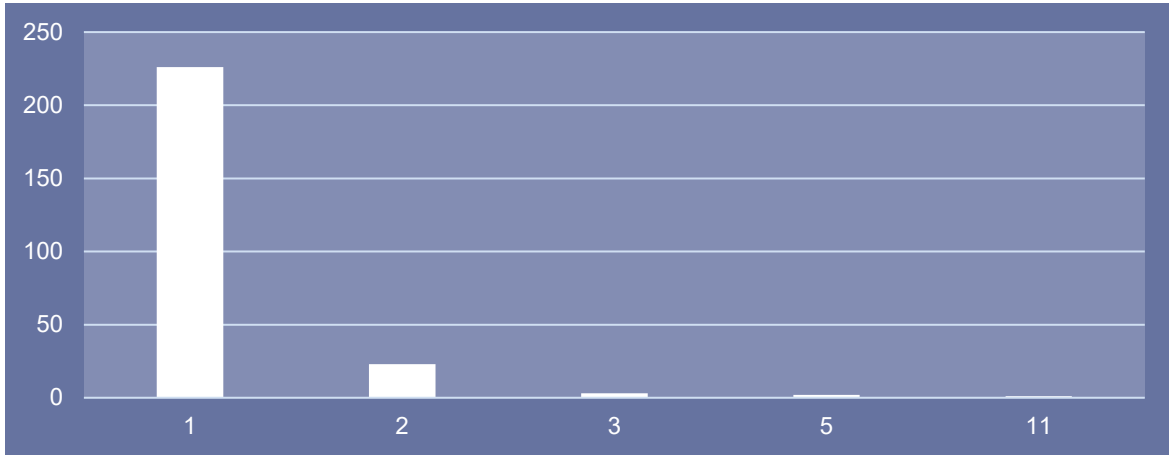
- The survey showed that 7.5% of SMEs are run solely by the owner due to the basic nature of the business, 51% operate with one to three employees, 41% with three to thirty employees, and only 8% have more than thirty employees.

Figure 19: SMEs by number of employees – Ministry of Planning definition of SMEs (left) and CSO definition of SMEs (right)



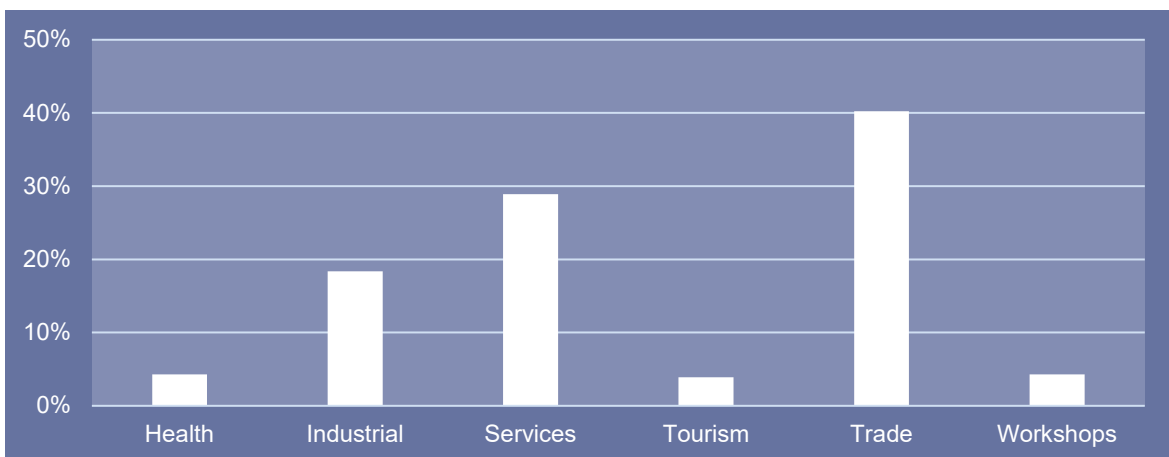
- In Iraq, 89% of SMEs operate only one establishment, with just 9% operating two. Depending on the nature of the business, this can represent an important potential opportunity for low-cost business development by SMEs beyond their local market, particularly if they use online card payment, e-points of sale (POS) deployment and digital finance to develop a customer base at the regional and national level.

Figure 20: SMEs by number of establishments



- The SME sector is largely dominated by trade activities (40%) and service (30%) activities. The manufacturing of industrial products is over-represented in the sample, at 20%, with a view to presenting a more in-depth analysis of this segment. In most studies, however, it is estimated to account for just 5% to 7% of total SMEs in the market. Few SMEs are engaged in agricultural activities as most agriculture is performed by microenterprises. The figures show that:
 - Iraqi SMEs are mainly active in high-profit margin fields (i.e. trade and services) which usually present very low to low/average risk profiles for formal external financing. The high percentage of trade businesses reflects Iraq's heavy dependence on imports for basic necessities, including food, medicine and energy.
 - The agricultural sector, which has very low profit margins, is mainly formed by microenterprises and therefore less attractive for traditional external financing. It requires special financing solutions and products tailored to their specific needs.

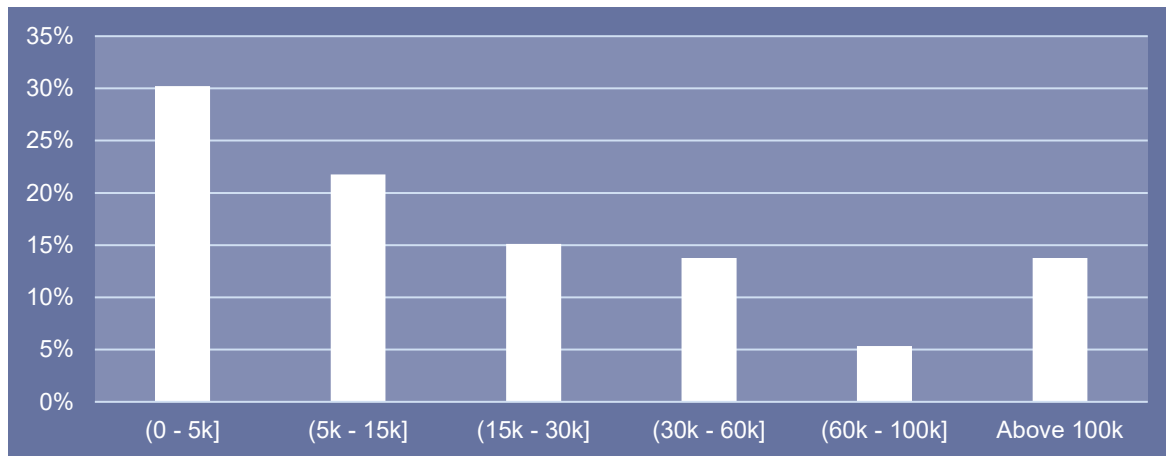
Figure 21: SME distribution by economic sector



- In terms of asset size (excluding buildings), almost 52% of Iraqi SMEs operate with equipment and machinery with a total value of less than USD 15,000, which is below the

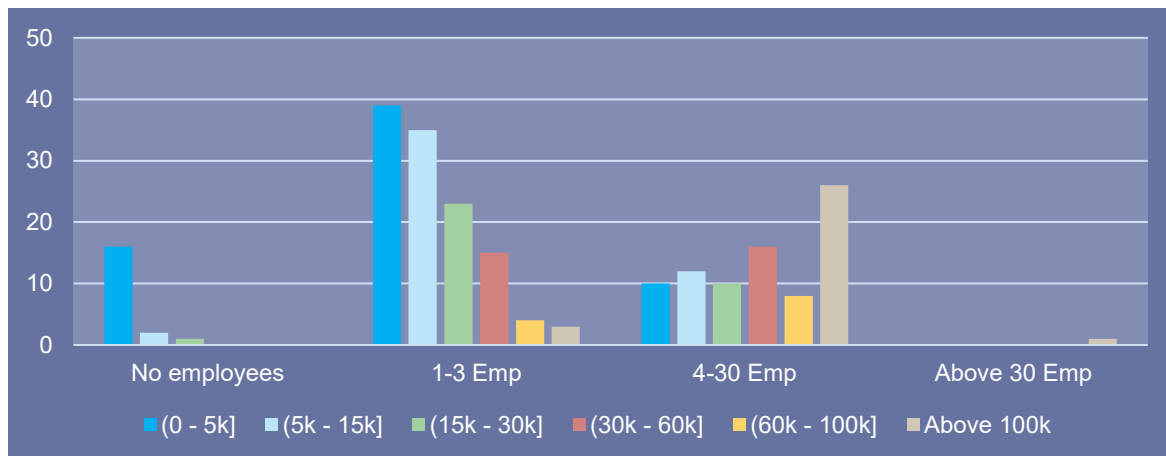
amount of their average financing needs. Their equipment and machinery does not therefore qualify, according to bank criteria, as acceptable movable assets for loan collateral.

Figure 22: SME distribution by value of business equipment/machinery



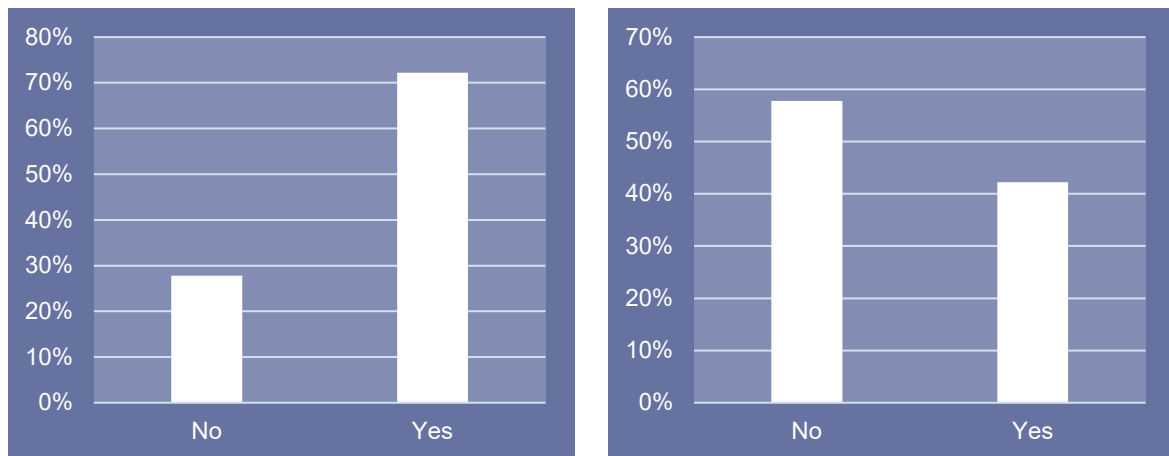
- On average, one-person businesses have equipment worth less than USD 5,000, while those with more employees have equipment worth more. For instance, businesses with four to thirty employees commonly possess equipment with a value of more than USD 100,000.

Figure 23: SME distribution by number of employees and value of business equipment/machinery (USD)



- 72% of SMEs surveyed use social media for marketing, while 42% provide delivery services via the internet, indicating a high level of internet and e-commerce culture, which is very favourable for the development of digital financing tools and products for SMEs in Iraq.

Figure 24: SMEs using social media for marketing (left) and the internet for delivery (right)



Key recommendations for action

- **Given that the equipment and machinery of the majority of Iraqi SMEs is worth less than USD 15,000 – below the amount of their average financing needs – and does not therefore qualify as credible collateral, leasing and Islamic financing, where the financing institution remains the owner of the equipment to be acquired by the enterprise, are two financing vehicles that have considerable potential for the SME lending market.** It is worth noting that Islamic financing is a) structurally more expensive than leasing in terms of monthly payments because they are calculated on the total value of the acquired asset rather than on the total value of the acquired asset minus its resale value at the end of the lease, and b) structurally as complex as a traditional loan in terms of implementation.
- **The use of online card payment, e-POS deployment and digital finance is essential in enabling the 89% of SMEs (depending on the nature of the business) operating from just one establishment to expand their customer base at the regional and national level for business development at a very low cost.**
- With 72% of SME owners/managers using the internet for marketing and 42% for product and service delivery, Iraqi financial intermediaries should engage, in cooperation with the CBI, in the development of enterprise financing tools and products with high potential for a profitable market breakthrough in a digital finance market that always rewards market firsts with solid and sustainable comparative advantages.

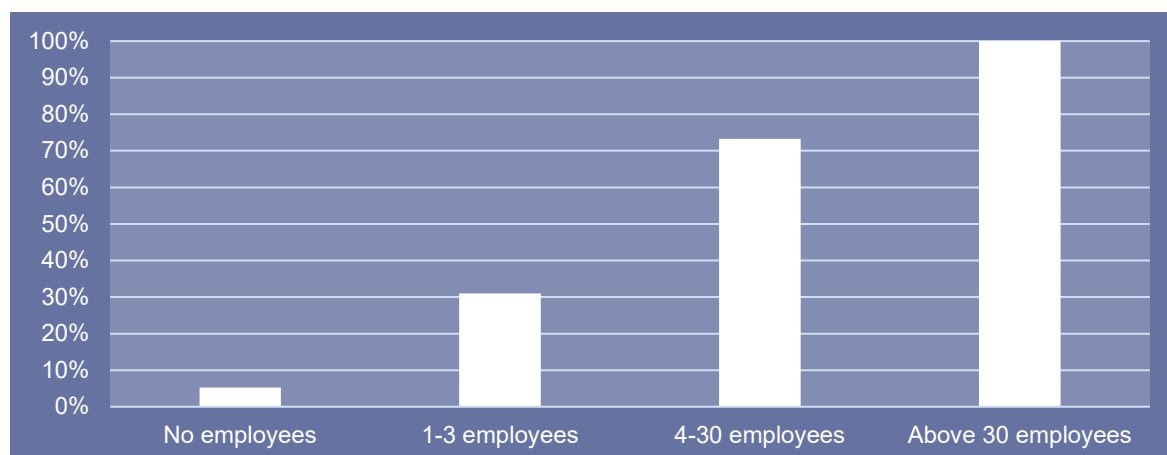
7.4 Sources of financing and banking

Iraq has one of the lowest rates of financial penetration in the MENA region. According to the ILO (2020), formal financial inclusion in 2017 was 22.7% (19.5% for women).

Key observations

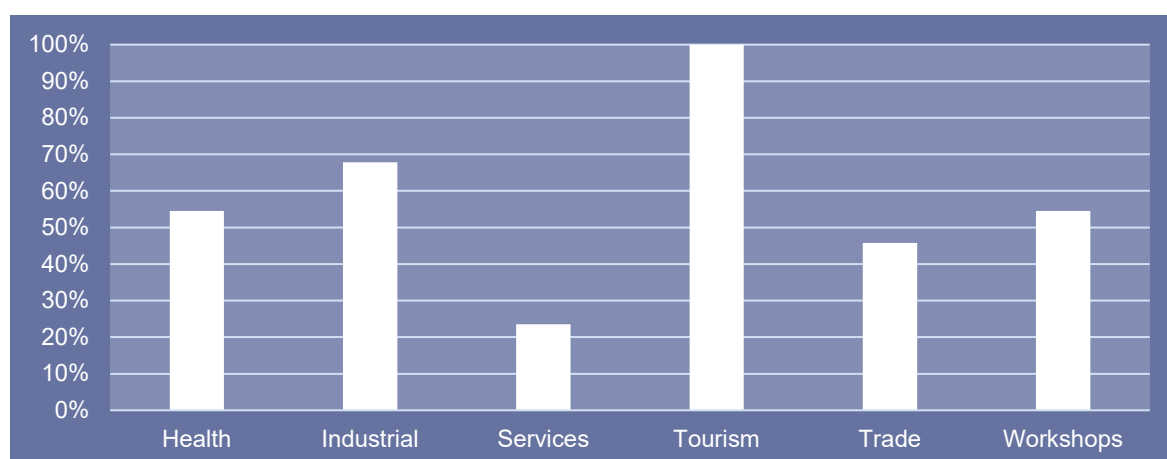
- According to our survey, 95% of very small enterprises (microenterprises) and 69% of small enterprises do not have a bank account, while 73% of medium-sized and large enterprises do have one. In the 2022 UNDP study on SMEs in the Kurdistan Region, it was found that only 1.5% of the sampled businesses used banking services, although, as mentioned above, the UNDP study focused mainly on microenterprises.

Figure 25: SMEs with a bank account by number of employees



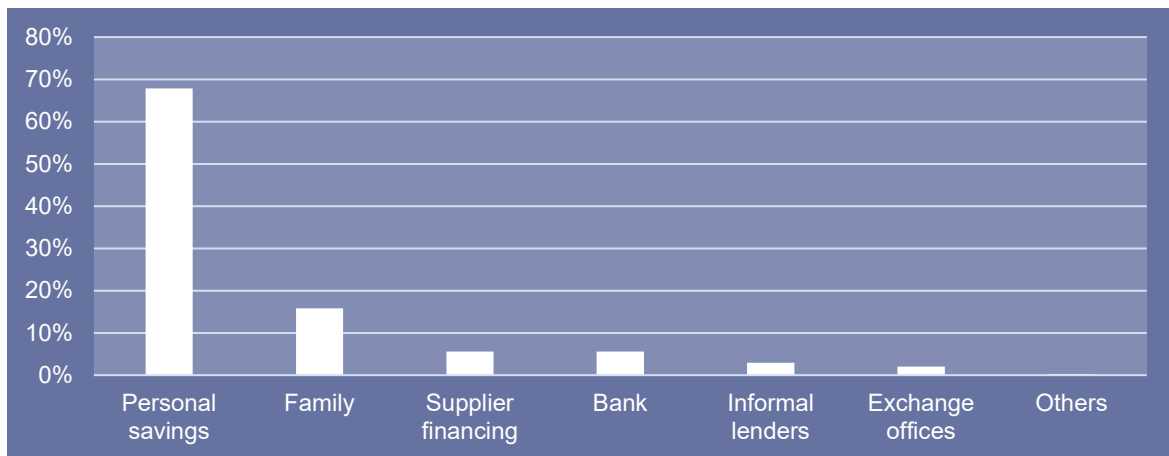
- Our survey shows that the two key factors behind the unwillingness of businesses to open bank accounts are distrust in the liquidity of banks (notably private ones) and the excessive documentary and procedural requirements for opening an account. For example, it is not uncommon for banks to require a referee before they agree to open an account for an individual.
- **Electronic payment service providers interviewed indicated that merchants/shop owners refrain from hosting POS/credit card terminals as they find it challenging to open a bank account.**
- Sector-wise, industrial SMEs have a high rate of banking experience thanks to the facilitation role played by the IFI.

Figure 26: SMEs with a bank account by sector



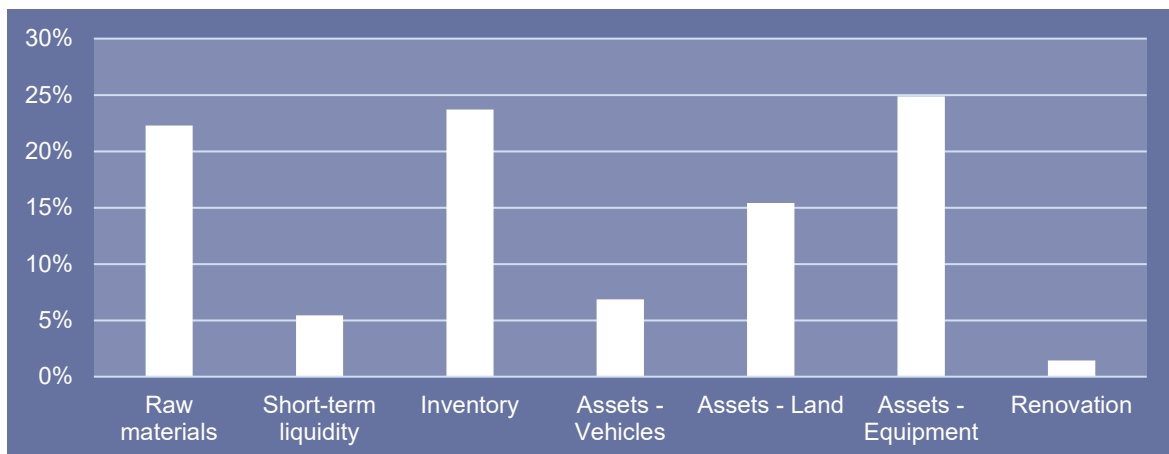
- The vast majority of SME business owners/managers rely on personal and family resources to establish, run and develop their business. The survey showed that 68% rely on personal savings to finance their business, while 16% rely on funds from family members.
- Only 6% of surveyed SME owners/managers reported having a bank loan.

Figure 27: SME distribution by source of finance



- When applying for credit, 22% of SME owners/managers indicated that they needed short-term financing to purchase raw materials, 24% short-term financing to increase the quantity of goods they had to sell, 16% long-term financing to acquire land and real estate for the business and 25% medium-term financing to purchase equipment.

Figure 28: Breakdown of SMEs by intended use of potential credit



Key recommendations for action

- **Documentary and procedural requirements for opening a bank account must be simplified and streamlined** in order to overcome the reluctance of merchants/shop owners to open a bank account (prerequisite to POS implementation), as reported by surveyed POS service providers.
- **It is necessary to carry out campaigns to promote POS deployment, clearly highlighting the concrete benefits for merchants and shop owners in terms of business development and increased sales through outreach to non-local customers.**
- **Iraqi financial intermediaries, the government and the CBI should focus on the development and implementation of short-term and medium-term financing products for the acquisition of raw materials, stock to sell and production equipment – the main**

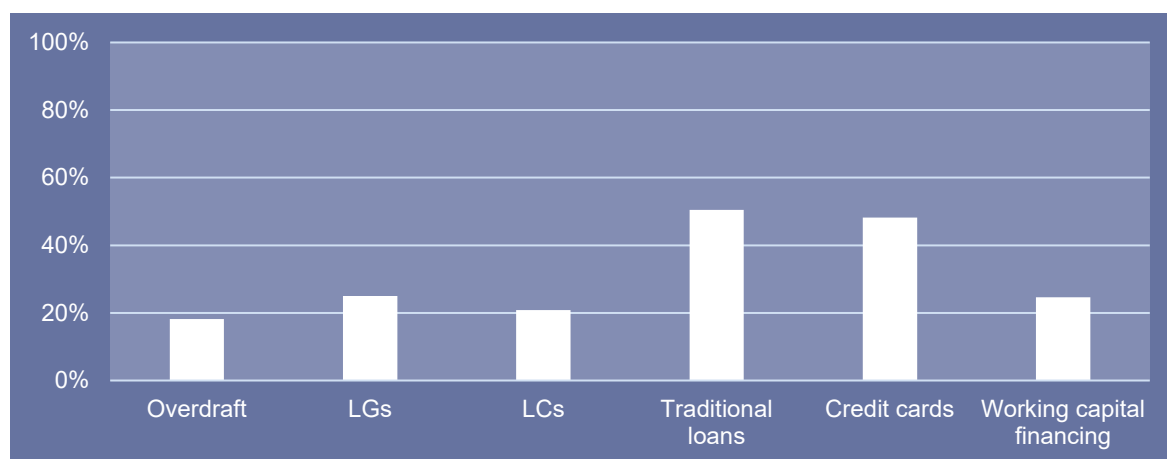
financing needs of bankable SMEs – before turning their attention to long-term financing for land and real estate for business establishments.

7.5 Knowledge of credit products

Key observations

- The vast majority of surveyed SMEs have never heard of any financing products for SMEs other than traditional loans.
- **More than 75% of surveyed SMEs did not know about overdrafts, letters of credit (LCs), letters of guarantee (LGs) and working capital financing.**
- This lack of knowledge about banking products among SMEs is **greatly exacerbated by the banks' lack of visibility. During the time the experts were on site, it was observed that the banks made practically no effort to advertise and market their products.** Banks seem to operate in silos with no interest in further enhancing their corporate and personal customer base.

Figure 29: Knowledge of specific SME products among SME owners



- During interviews with governorate heads of chambers of industry, many mentioned that the SMEs in their region lack very basic knowledge about financial management. For instance, many SME owners recklessly increase personal and household spending using credit funds that are meant to be used to grow the business. **The concept of mandatory savings was introduced and managed by certain chambers of industry in order to educate SMEs on the concept of deferred payments.**

Key recommendations for action

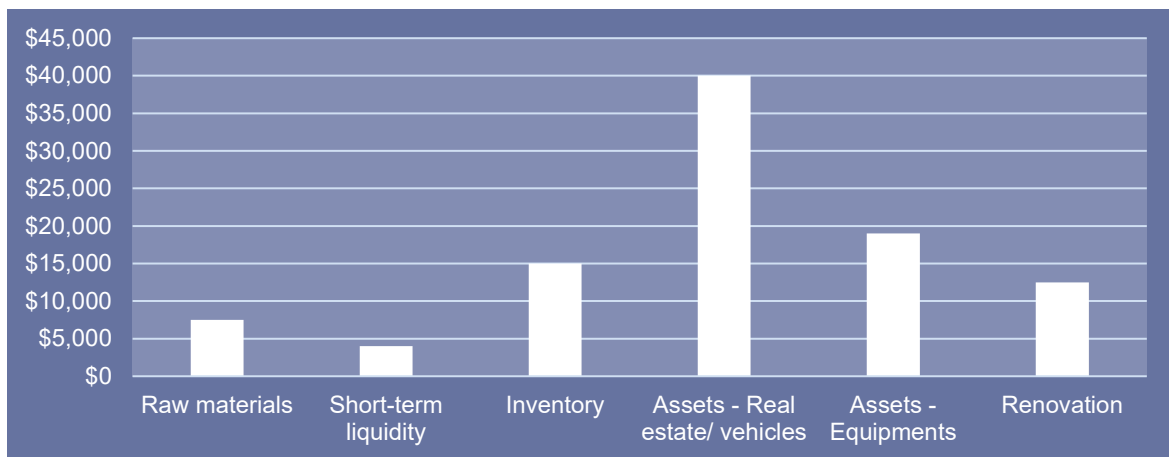
- Massive communication campaigns should be carried out to spread banking literacy among SMEs, particularly to increase understanding of the different credit products available that would be suited to meeting their financing needs.
- Massive training campaigns should be carried out to increase the knowledge of SME owners/managers about the basic concepts of financial management, bookkeeping and planning.

7.6 SME financing needs (amount, term and collateral)

Key observations

- The average financing amount required by SMEs is USD 33,020¹⁴, but if one takes out requests for extreme amounts, the median financing amount, i.e. the most typical amount requested is USD 10,000, reflecting the fact that most SMEs are small businesses.¹⁵
- Short-term liquidity financing needs involve very small amounts at an average of USD 3,000.
- Raw materials and inventory financing needs involve small amounts – USD 7,500 and USD 15,000 respectively.
- Production assets and equipment financing needs involve relatively small amounts at an average of USD 18,000.
- Vehicle and real-estate financing needs involve larger amounts at an average of around USD 40,000.

Figure 30: Average loan amount for SMEs by intended use (in USD)

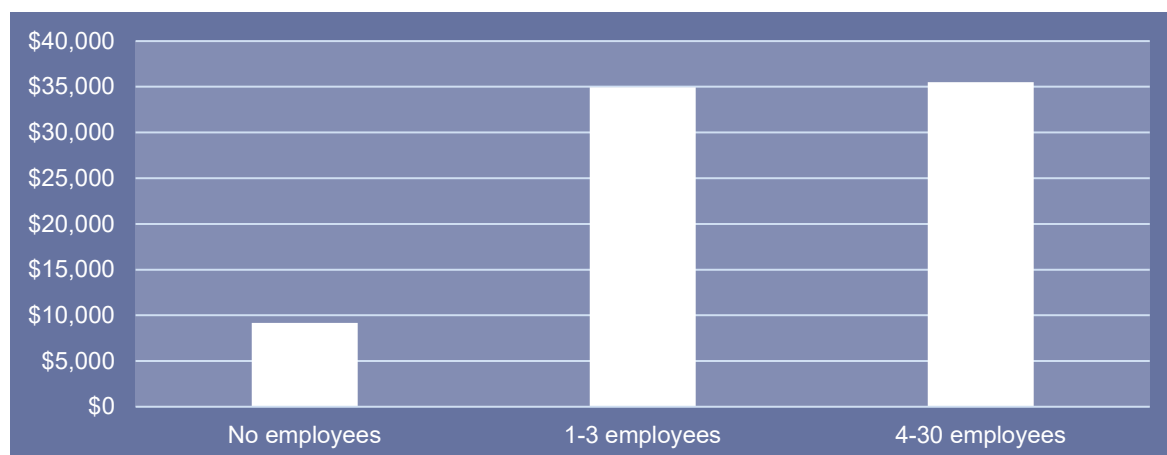


- The average financing amount sought by single-person enterprises is USD 9,000.
- The average financing amount for enterprises with one to three employees and four to thirty employees is very similar at around USD 35,000.

¹⁴ The calculation excludes survey responses indicating amounts above USD 500,000.

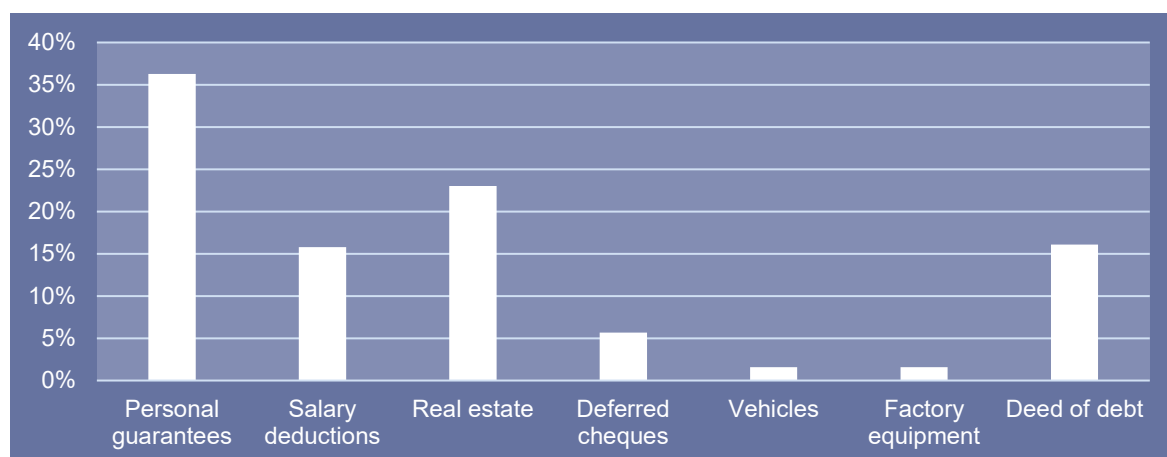
¹⁵ When data are skewed or have outliers (i.e. large number of small and medium values and a few large values or vice versa), the “average” tends to be distorted. In such cases, the “median” is worth considering as a truer indicator: The “median” is the value in the middle of a data set, meaning that 50% of data points have a value smaller or equal to the median and 50% of data points have a value higher or equal to the median.

Figure 31: Average loan amount for SMEs by number of employees (in USD)



- Based on the amounts indicated by SMEs for their individual financing needs in this survey and the number of Iraqi SMEs estimated by the IFC, estimated overall market needs are between USD 3.77 billion and USD 8.40 billion.¹⁶
- Only 16% of SMEs can provide salary-based guarantees.
- Personal guarantees,¹⁷ real-estate or mortgage collateral, deeds of debt¹⁸ and salary-based guarantees are the preferred form of guarantee/collateral for SME owners/managers.

Figure 32: Preferred form of guarantee of SME owners/managers¹⁹



¹⁶ Based on these estimations, the CBI One Trillion Dinar Initiative (See section 6.3) covers 20.09% and 9.02% respectively. As indicated in the next section on the obstacles to accessing finance, the potential of the Iraqi financing market for SMEs is hindered by a confluence of factors, coupled with the lack of collateral and the absence of an effective credit guarantee scheme for SMEs without collateral.

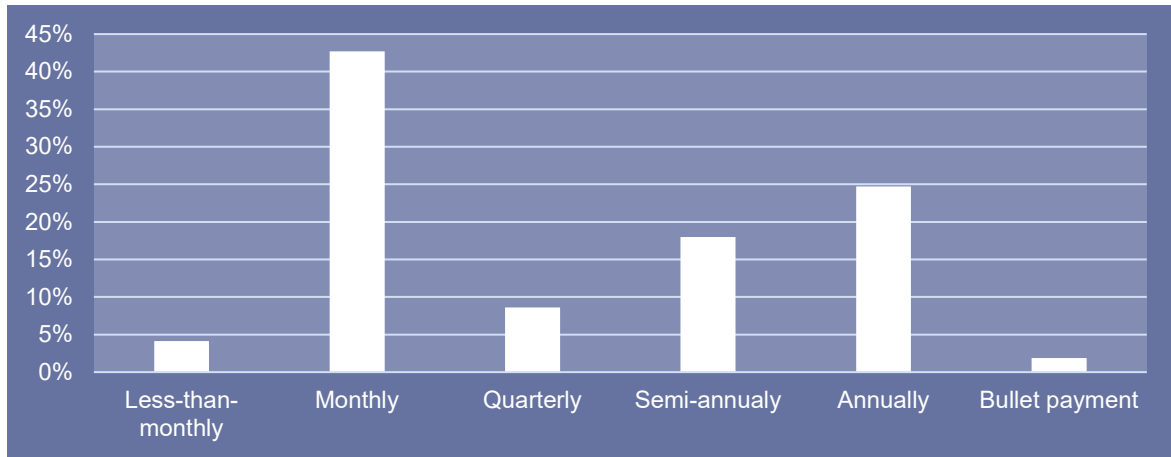
¹⁷ Personal guarantees are those provided by a non-salaried guarantor, typically a self-employed person.

¹⁸ Commercial paper signed by the borrower which has serious legal implications in the event of default.

¹⁹ It is worth noting that the findings shown on this graph are largely biased by what SMEs already know about what Iraqi banks accept as guarantees. For instance, many of the SMEs interviewed were surprised that vehicles can be pledged as collateral in most other countries, which explains why surveyed SME owners/managers probably did not consider this option in their response.

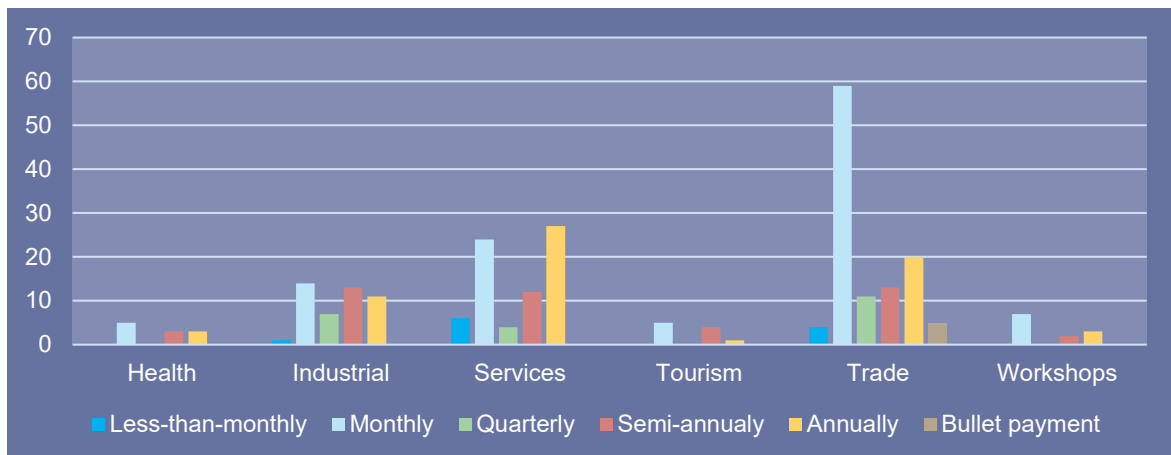
- The survey shows that 42% of SME owners/managers prefer monthly loan repayments, 25% prefer annual repayments and 18% prefer semi-annual payments.

Figure 33: Breakdown of SMEs by preferred repayment interval



- There is a relatively high demand for financing products with an annual repayment plan for industrial and service businesses. This is probably due to the seasonal nature of the activities they carry out.

Figure 34: Breakdown of SMEs by preferred repayment interval and sector



Key recommendation for action

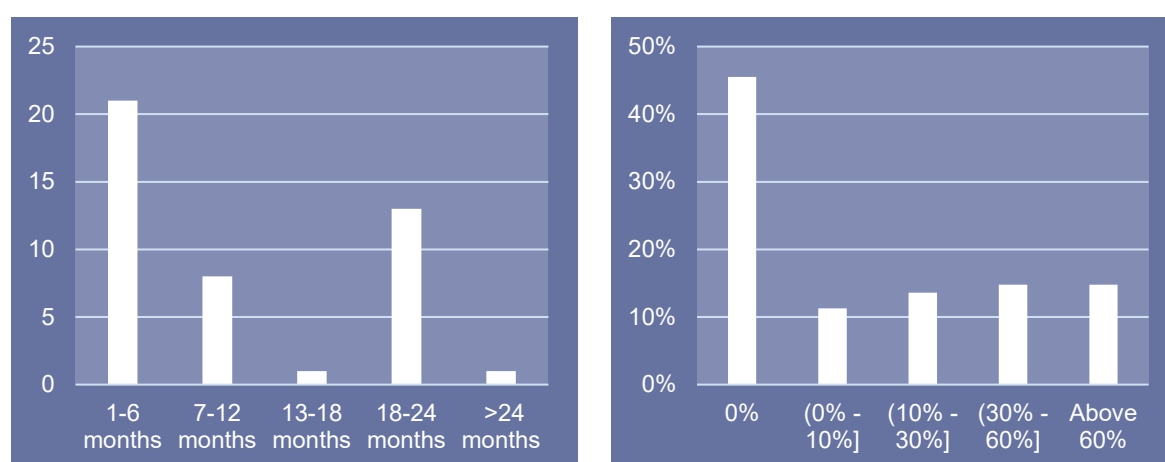
- **The CBI and the donor community are advised to support banks in operating outside the comfort of the CBI initiative and developing banking products with different specifications, collateral requirements and intended uses.** The absence in the market of products for financing short-term liquidity needs is particularly noteworthy. The products should be designed to accommodate the length of SME cash cycles. For very short-term cash needs, overdraft facilities should be offered. For seasonal financing to cover the purchase of raw materials, working capital loans should be offered.

7.7 SME liquidity and cash cycle management

Key observations

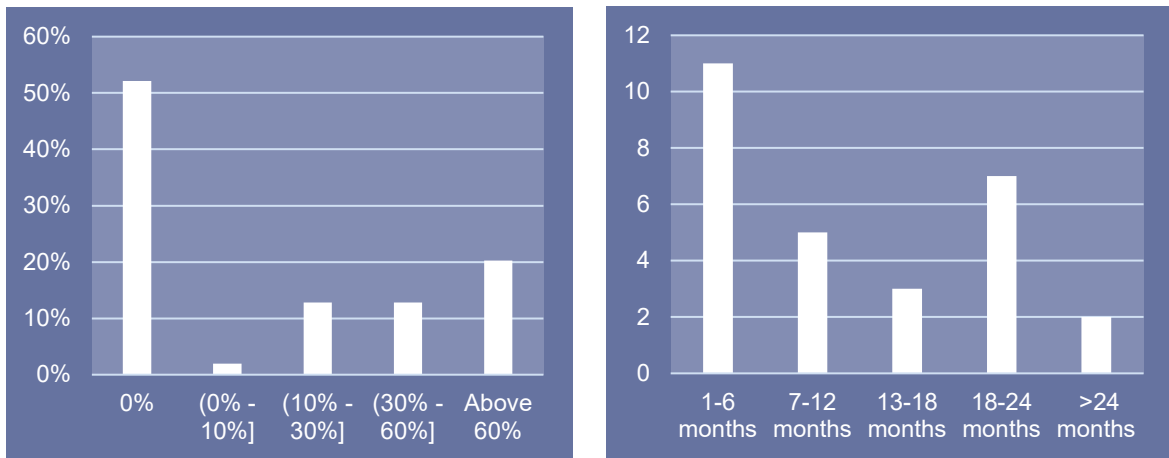
- SMEs rely extensively on sales on credit to customers (55% of surveyed SMEs sell on credit, of which one third have more than 30% of their sales on credit).
- Of the SMEs that sell on credit to customers, 47% reported that the average length of the credit period was between one and six months, and 50% reported that it was between six and eighteen months. **Such enterprises make ideal candidates for revolving credit products which are not offered to SMEs by most banks.**

Figure 35: SMEs by percentage of sales on credit (left) and by average length of credit period in months (right)



- SMEs rely heavily on credit to purchase equipment and materials for their businesses (47.8% of SMEs purchase materials on credit, of which 33% have more than 30% of their purchases on credit).
- Of the SMEs that purchase on credit, 39.2% reported that the average length of the credit period was between one and six months, and 53.57% reported that it was between six and eighteen months. **As in the case of sales on credit, these enterprises make ideal candidates for revolving credit products which are not offered to SMEs by most banks.**

Figure 36: SMEs by percentage of purchases on credit (left) and by average length of credit period in months (right)



Key recommendation for action

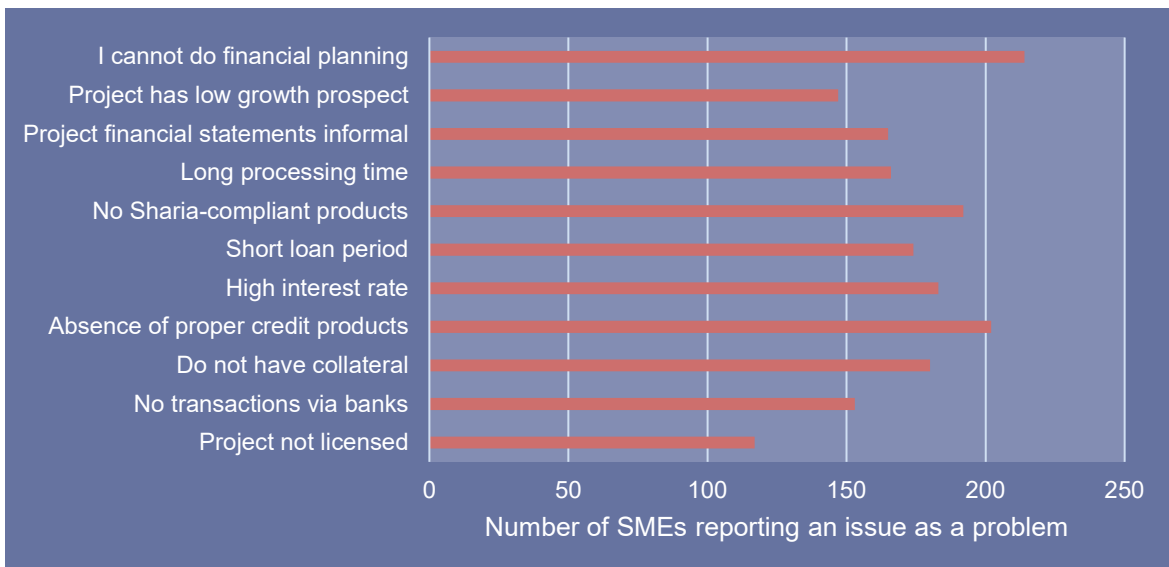
- The customer credit system used by many SMEs should encourage banks to develop revolving credit products (not currently offered by most Iraqi banks or financial intermediaries) for SMEs and their customers.

7.8 Obstacles to SME access to credit

The obstacles to access to finance will be discussed in depth in a dedicated report, given the interlinkages between supply and demand side factors, that is, obstacles for banks and obstacles for SMEs.

This report describes the obstacles on the demand side – those faced by SMEs.

Figure 37: Obstacles to access to finance from the SME’s perspective



Key observations

Overall, SMEs regarded most of the obstacles listed in the survey as valid and classified them as major constraints, although the following emerged as the most important:

- Most SMEs reported that the instability of the dinar's exchange rate has been a major factor in creating uncertainty about the future of their business and their ability to repay loans.
- SMEs also reported that their lack of financial planning capacity is a major challenge. They feel that they lack the ability to decide what loan they would need and could afford and to do what is necessary to secure a loan and manage the funds successfully.
- The absence of specific financing products tailored to meet the real needs and particular circumstances of SMEs.
- The lack of Sharia-compliant products is reported as a major obstacle in the market for many Iraqis who refuse to engage in a conversation with a bank once interest rates are mentioned. In very conservative areas of the country, initiatives such as the one carried out by the ILO have designed successful non-Islamic financing schemes that obviate the concept of interest payment in order to reach out to local SMEs.
- The lack of collateral is a major challenge for SMEs in securing financing. The credit guarantee scheme operated by banks focuses almost exclusively on salary-based guarantees from civil servants, and the pool of individuals able and willing to provide such guarantees has now dried up.
- During the focus group discussions with bank customers and the IFI, it was repeatedly reported that the capacity to provide guarantees in the Iraqi market has been almost totally exhausted as every civil servant has guaranteed at least one or two borrowers, and they are also borrowers themselves!
- It is estimated that more than 60% of industrial enterprises are established on sites designated by the government as agricultural land. Such legal designations encompass more than 90% of the country's total area. This is a major concern for factory owners as they operate on land for which they possess no title deed. Consequently, they cannot offer any form of immovable collateral to banks if they wish to apply for a loan. It was mentioned that the Cabinet is currently working on regulations to facilitate land title transfer to established industrial undertakings so that they have credible collateral that will be accepted by banks.

“My factory's equipment is worth 10 times the amount of the loan I requested, but because the land on which the factory is built is designated as agricultural land, the bank will not accept it as collateral, which means I cannot apply for a loan.”

— *Industrial SME interview at IFI*

- Cumbersome procedures and lengthy processing times for loan applications are another of the key reasons why SMEs are deterred from applying for a loan. Banks request documents in an unprofessional and iterative way that costs applicants time and money. The issue of burdensome processes is even more serious in public banks. For example, the loan

application process at the Industrial Bank takes at least six months and can drag on for more than a year.

“ ‘Obtaining a loan is a long journey, and you need to decide if you want to go through the process or not before applying for the loan, preparing the required documents, looking for acceptable guarantors and waiting for the final decision; it all takes time.’ ”

— SME customer at a private bank

- Excessively high interest rates are a serious obstacle for SMEs. Iraqi banks have one of the highest spreads on credit products in the MENA region; it can be as much as 7% for SME loans. This makes the cost of formal external financing prohibitive for SMEs, even the most bankable ones.

Key recommendations for action

- Iraqi public and private banks must structure, optimise and streamline their internal processes to handle SME loan applications effectively.
- The Iraqi Cabinet needs to urgently step up efforts to formulate regulations that facilitate land title transfer to established industrial undertakings so that they have credible collateral that will be accepted by banks.
- There is an urgent need to establish a credit guarantee facility to compensate for the lack of acceptable collateral in the market (see previous recommendations).
- Iraqi banks must digitalise their lending operations.
- SME owners and managers must be provided with training covering basic concepts of financial management (see previous recommendations).
- **Islamic-compliant SME products are essential for many Iraqis, with 90% of surveyed SMEs reporting that the absence of Sharia-compliant products was a major deterrent to applying for a loan.** Commercial non-Islamic banks may therefore need to consider developing Sharia-compliant products and work on promoting them through public awareness campaigns.
- **Iraqi banks need to consider investing in the infrastructure necessary to increase their outreach to SMEs.** While the reality in Iraq is that banks have very small branch networks, reaching SMEs requires a wide geographical presence, which entails having a larger branch network across the country's different economic regions. Moreover, as SMEs become more tech-savvy, banks need to develop their digital infrastructure to onboard clients and process loan requests.
- Banks should develop financial products targeted at SMEs and designed to meet their specific needs in terms of amount, credit period, type of collateral and repayment intervals.

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Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

Registered Offices
Bonn and Eschborn, Germany

Friedrich-Ebert-Allee 32 + 36
53113 Bonn, Germany
T +49 228 44 60-0
F +49 228 44 60-17 66

Dag-Hammarskjöld-Weg 1 - 5
65760 Eschborn, Germany
T +49 61 96 79-0
F +49 61 96 79-11 15

E info@giz.de
I www.giz.de