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# IRAQ PRIVATE SECTOR GROWTH AND EMPLOYMENT GENERATION

FEBRUARY 25, 2007

## THE IRAQ MICROFINANCE STRATEGY



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# THE IRAQ MICROFINANCE STRATEGY

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## List of Acronyms

<b>ACSI</b>	Access to Credit in Southern Iraq
<b>BOP</b>	Bottom of the Pyramid
<b>CAP</b>	Community Action Program
<b>CBI</b>	Central Bank of Iraq
<b>CERP</b>	Commander's Emergency Response Program
<b>CGAP</b>	Consultative Group to Assist the Poor
<b>CPA</b>	Coalition Provisional Authority
<b>GOI</b>	Government of Iraq
<b>ICBG</b>	Iraqi Company for Bank Guarantees, Ltd.
<b>ICT</b>	Information and Communications Technology
<b>IMFI</b>	Indigenous Microfinance Institution
<b>IRMO</b>	Iraq Reconstruction Management Office
<b>IT</b>	Information Technology
<b>MFI</b>	Microfinance Institution
<b>MNF-I</b>	Multi-National Force-Iraq
<b>MIS</b>	Management Information System
<b>MSME</b>	Micro, Small and Medium Enterprises
<b>MOLSA</b>	Ministry of Labor and Social Affairs
<b>NGO</b>	Non-Governmental Organization
<b>PAR</b>	Portfolio at Risk
<b>PRT</b>	Provincial Reconstruction Team
<b>PVO</b>	Private Voluntary Organization
<b>SBDC</b>	Small Business Development Center
<b>SME</b>	Small and Medium-Sized Enterprise
<b>ToT</b>	Training of Trainers

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# Executive Summary

In November 2006, the first ever Iraq Microfinance Summit (the Summit) was held in Erbil, Iraq. The Summit brought practitioners, donors, and other interested supporters together to take stock of the Iraqi microfinance industry, outline the issues facing microfinance in Iraq today, and discuss donor and practitioner objectives achieved through microfinance. The Summit provided a forum in which all stakeholders could frankly exchange views about the state of Iraqi microfinance and the ways to best develop the industry going forward.

The Summit served as the platform for developing a comprehensive strategy for microfinance in Iraq. Immediately following the Summit, a working group (known as the Microfinance Strategy Working Group) convened to discuss the key issues affecting Iraqi microfinance and to prioritize the objectives of Iraqi MFIs, practitioners, and donors. The *Iraq Microfinance Strategy* results from the efforts of this Working Group and with drafting and technical support furnished by the Iraq Private Sector Growth and Income Generation project (IZDIHAR), which is funded by the United States Agency for International Development (USAID).

The *Strategy* represents the consensus views of Iraqi MFIs, practitioners, and other key stakeholders. The *Strategy* is designed for the near and mid-term (a period from three to five years). It will be driven by Iraqi microfinance institutions (MFIs) and practitioners through their business plans and work. The programs, policies, and priorities of donors, policymakers, and others will also affect the implementation of the *Strategy*. Accordingly, it will be periodically reviewed and assessed, and as appropriate adjustments made to it.

The six strategies that make up the *Iraq Microfinance Strategy* are:

1. Promoting awareness of microfinance and its benefits. This awareness-building program is focused on the client base of MFIs, donors, government officials and policymakers, and the banking industry.
2. Seeking a legal and regulatory environment that supports establishment of new MFIs and the integration of MFIs into the financial community.
3. Capacity building through training and other programs.
4. Emphasizing transparent operations with internationally accepted standards and reporting, and the use of computer-based record keeping for administrative, managerial, and evaluation purposes.
5. Supporting industry development through formal and informal networking opportunities, while ensuring that appropriate levels of information security are maintained.
6. Increasing business opportunities with the banking industry to: (i) provide MFIs with needed banking services; and (ii) promote partnering arrangements between MFIs and banks.

Each of these strategies is discussed in Section 3. In addition, Section 1 provides definitions and background information, including the role of microfinance in the development agenda. It is especially useful for those without specialized microfinance knowledge. Section 2 discusses Iraqi microfinance, placing the six strategies within the context of the current environment. It also provides a basis for non-specialists in microfinance to understand the

reasons for each particular strategy. Section 4 is a special note to donors, policymakers, and others that outlines, from the industry's perspective, relevant issues affecting microfinance development. The table in Section 5 summarizes how the strategies will be implemented, and is followed by Section 6, the conclusion.

The *Strategy* provides a basis for discussions about microfinance with key policymakers and officials within the Government of Iraq, with donors, and with other microfinance stakeholders. The Strategy plays a key role in Iraq's future.

Iraqi MFIs are encouraged to reflect the strategies in this paper in their organizations and operations. There is a very large demand for microfinance in Iraq. The conflict and other complicating factors in Iraq make delivery of microfinance services very challenging. It is believed these challenges can be best faced by thorough consideration of the *Strategy* and by focus on the six strategies by all those interested in expanding the delivery of microfinance in Iraq.

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# Introduction

This paper sets out broad directions and priorities to guide development of the Iraqi microfinance industry in the mid-term, along with an action plan for implementing this strategy.

The strategy is the outcome of the Iraq Microfinance Summit (the Summit) held in Erbil, Iraq in November 2006, and further collaboration with microfinance implementers on this draft document. At the Summit, practitioners, donors, and experts in the microfinance industry discussed their objectives and strategies for implementing microfinance in Iraq, and identified key issues and challenges affecting Iraqi microfinance institutions (MFIs). Those attending reached consensus on the six key strategies that collectively form the *Iraq Microfinance Strategy* (the *Strategy*).

Section 1 of the *Strategy* provides definitions and background information, including the role of microfinance in the development agenda. It is especially useful for those without specialized microfinance knowledge. Section 2 discusses Iraqi microfinance, placing the six strategies within the context of the current environment. It also provides a basis for non-specialists in microfinance to understand the reasons for each particular strategy. Section 3 details the six key strategies for Iraqi MFIs and practitioners. Section 4 is a special note to donors, policymakers, and others that outlines, from the industry's perspective, relevant

issues affecting microfinance development. The table in Section 5 summarizes how the strategies will be implemented, and is followed with the Conclusion in Section 6.

***How Much Does Microfinance Influence Development?***

*"Few fields in development or commerce emphasize both economic and social performance as strongly as microfinance."*

D. Tulchin, *Microfinance's Double Bottom Line*, December 2003.

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## Section 1

# Global Microfinance

## 1.1 What is Microfinance?

Most people consider microfinance as extending small loans (\$50 to \$1,500) to those who could not access credit from banks or other financial institutions. Loans are typically made to micro enterprises (very small businesses: one to three employees), with the market including inhabitants of rural areas, the urban poor, and women. Microfinance methodology often employs collateral substitutes to deliver and recover short-term loans to micro entrepreneurs (or potential micro entrepreneurs).

This traditional concept of microfinance has changed over time as lessons were learned and programs expanded. In many countries today, microfinance has expanded beyond this traditional concept of lending to micro enterprises. In fact, persons without access to the formal banking system need, use, and benefit from different kinds of financial services in addition to loans:

Over the past 10 years or so, microfinance has rapidly evolved and expanded from the relatively narrow field of microenterprise credit to the more comprehensive concept of microfinance (which includes a range of financial services for poor people, including savings, money transfers, and insurance) to the enormous challenge of building inclusive financial systems.<sup>1</sup>

## 1.2 Global Demand for Microfinance

Some 70 percent of the world's poorest people are concentrated in developing countries and living mainly in rural areas, and for many of these people, agriculture is the main source of economic growth, which is the cornerstone of poverty reduction.

Best practices have shown that poor people who have taken small loans to start new enterprises or expand ongoing ones have taken advantage of increased earnings to improve consumption levels, send their children to school, and build their assets. They have accumulated savings to provide protection against illness and have accessed better health care. Women, in particular, have been the focus of many microfinance programs, since it empowers them to participate in important decisions that affect their lives.

For microfinance to grow, it is essential that MFIs develop a deeper understanding of their clients' lives and of how they can best serve their needs.

## 1.3 The Supply of Microfinance

The past thirty years have seen strong supply growth in both established MFIs and the number of new entrants to the market. The demand and supply for microfinance clearly provides a means for increasing family income, for development of the financial sector, and for overall economic expansion: the poor households and micro enterprises that access microfinance can increase their income-generating potential, while their patronage of MFIs in turn ensures the growth and viability of MFIs as long-term financial services providers in the community.

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<sup>1</sup> Helms, *Access for All: Building Inclusive Financial Systems*, CGAP, 2006, page 2.

The challenge is how to turn effective demand for microfinance into effective supply of microfinance and financial services. Each one contributes to the other's growth or failure. The value chain in microfinance is that institutions provide financial services to the poor and micro-entrepreneurs, thus contributing to their viability and growth and the micro-entrepreneurs in turn contribute to the viability and growth of microfinance institutions. The viability and profitability of micro entrepreneurs and microfinance institutions are intimately linked and mutually reinforcing in a virtuous circle.

In addition, there are major differences between urban and rural supply of financial services, with the rural supply showing the major challenge in most parts of the world due to its remoteness or because the population is spread thinly over a large region.

Most microfinance institutions start as NGO-based credit-only programs funded by international donors. Recent trends have shown that commercial banks have entered the microfinance market serving micro, small, and medium enterprises, and there are emerging microfinance investment funds, a new trend leveraging private equity for economic growth and poverty reduction. Successful microfinance institutions have proven that providing

#### What is Microfinance?

Microfinance is one way of fighting poverty ... . It puts credit, savings, insurance and other basic financial services within the reach of poor people. Through microfinance institutions such as credit unions and some non-governmental organizations, poor people can obtain small loans, receive remittances from relatives working abroad and safeguard their savings. Accessing small amounts of credit at reasonable interest rates gives people with the willingness and know-how an opportunity to set up a small business. Records show that poor people are a good risk, with higher repayment rates than conventional borrowers.

IFAD, *Microfinance: Macro Benefits*, published by IFAD (the International Fund for Agricultural Development).

financial services to the poor can be an effective means to reduce poverty and be a sustainable and profitable business.

Most MFIs do not reach large numbers of poor people. Programs therefore need to be designed to include the poorest, and to facilitate mechanisms that will lead to poverty impacts. MFIs need to increase their understanding of poverty, in order for them to take simple steps to improve their outreach and their effectiveness for the poorest.

Because microfinance is so new to Iraq, the opportunity exists to develop the industry based on experiences in other countries and the lessons learned from its long

history. In order to place the global microfinance experience in the context of Iraq, the next section discusses microfinance as it is currently practiced in Iraq.

## Section 2

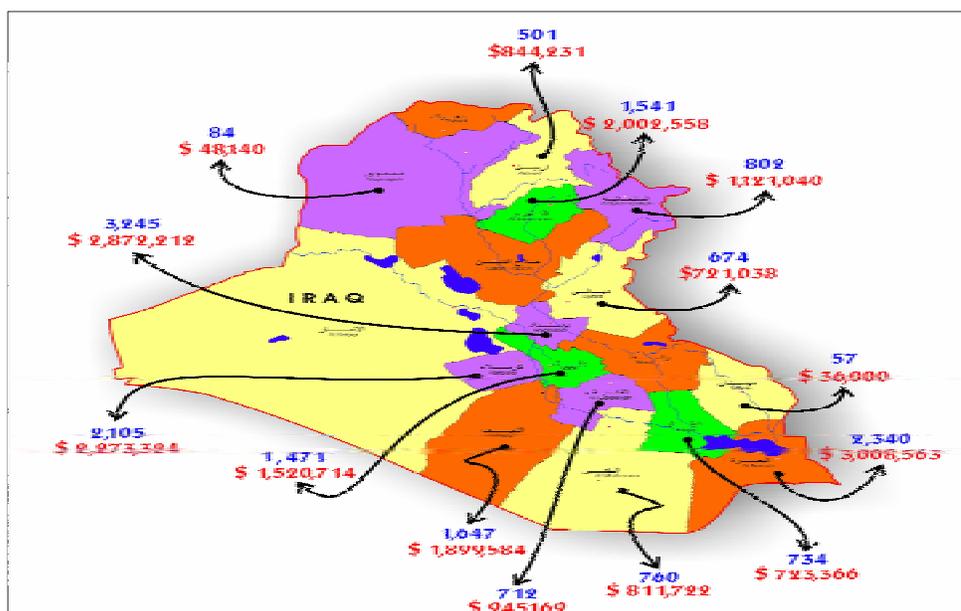
# Iraqi Microfinance

## 2.1 Introduction of Microfinance in Iraq

Microfinance is relatively new to Iraq, and the current Iraqi environment presents unique challenges for effective provision of financial services to the poor and their enterprises, as well as to small businesses in general. The supply of financial services for Iraqi micro and small businesses is very limited, while households at the bottom of the economic pyramid are not considered bankable. Prior to May 2003, there were no identified formal sources of microfinance in Iraq. As is typical throughout the world, an informal market-driven system of credit delivery through moneylenders, family, friends, and suppliers seemed to operate quite freely. While such a system is generally efficient at a local level, it rarely reaches a large number of potential customers, and is often prohibitively expensive.

In the latter part of 2003, the Coalition Provisional Authority provided funding for a micro credit program in South Central and Southern Iraq, followed shortly by funding for a program in the North.<sup>2</sup> These programs have resulted in two large MFIs operating: one primarily in the North, and the other primarily in the South and in central Iraq. In early 2006, multi-million dollar grants were awarded to these MFIs, as well as to a third large MFI. In addition, two indigenous microfinance institutions (IMFIs), one in central Iraq and the other in the North, started operations in the fall of 2006 using funding from IZDIHAR. The following map shows the outreach of the microfinance industry in Iraq as of November 2006: 16,673 loans totaling \$18,276,661 in fourteen governorates throughout Iraq.

**Iraq Microfinance Outreach, November 2006**



<sup>2</sup> See *Status of the Microfinance Industry in Iraq*, prepared by the USAID IZDIHAR project, presented in November 2006 at the Iraq National Microfinance Summit (reproduced in Annex 5).

Currently there is a very limited supply of microfinance services in Iraq; the five MFI programs discussed above serve approximately 17,000 active loan clients. Commercial bank lending to micro and small businesses is very limited. Demand from the core microenterprise level of informal sector businesses is not being met by current providers. Most professionals believe there is a financing gap and need for additional investment in microfinance industry development to meet this demand.

All of the existing MFIs operate in a challenging environment with an ever-changing security situation. The hiring, training, and retention of qualified personnel remain difficult. While loan repayment is generally quite good – in most cases excellent – operating costs remain high due to the costs of security.

Despite the obstacles, donors and NGOs alike continue to move forward with plans for expanded services and locations and are continually adjusting as conditions change. Training programs offered by internationally acclaimed training institutions are not only turning out qualified microfinance professionals, they are also developing a cadre of Iraqi trainers through a Training of Trainers (ToT) program. Proven loan tracking and accounting software, specifically designed for MFIs, has been installed in the two IMFIs, while the three larger MFIs have their own accounting and loan tracking systems. In addition, existing MFIs have devoted substantial time to meeting with community leaders and discussing the role and mission of microfinance in their respective communities.

## 2.2 Defining What Is Implied by “Microfinance” in Iraq

In Iraq, the term “microfinance” describes an industry that addresses different objectives and targets different customers. It focuses on improving *household* income through provision of credit, usually for a business activity (but also for home improvement and other purposes). It also focuses on providing access to credit for micro and small businesses. Globally, microfinance is defined as the provision of financial services for poor households and the enterprises they run to sustain their livelihoods (see Annex 1 for a discussion of this issue).

Microfinance can contribute to overall economic development in Iraq through poverty reduction; it is a specialized methodology for ensuring access to financial services by the poorest segments of society that are excluded from access to conventional banking services. Microfinance focuses on improving the economic situation of the *household* through appropriate credit, savings and other financial services.

Specialized *business finance* services for small and medium size enterprises (SMEs) can contribute to economic development through employment generation, which could have a positive impact on stability in the current high-unemployment environment in Iraq. Demand for SME finance is generally focused on credit, and is typically offered by banks or other regulated financial institutions (as credit demand by SMEs is higher than for micro- and home-based business activities). The key to successful SME finance is the ability of the provider to accurately assess the cash flow and repayment capacity of potential borrowers.

In Iraq, “microfinance” has been used by donors and policymakers to refer to financial services offered to households as well as to micro, small, and medium size businesses. While it is possible for a financial services provider to offer products that serve both market segments, it is important to recognize the differences in the methodologies that make each product line successful. It is equally important to recognize that the goals that can be achieved differ between the two methodologies: microfinance will affect poverty reduction more effectively than SME finance, while SME finance is a better tool for employment

generation. By nature, neither methodology is very suitable for short-term goals, which is not always sufficiently acknowledged by the donor: spurring economic development is inevitably a long-term endeavor.

The MFIs currently operating in Iraq have their core competence in microfinance rather than SME finance. However, this *Strategy* includes efforts to bridge the supply gap in financing in order to serve a larger segment of the Iraqi population of poor households as well as micro, small and medium size businesses. It should therefore be understood that the term “microfinance” in this *Strategy*, covers a range of financial products and services that are applicable, not only to poor households, but also to micro, small, and medium size enterprises, and in many countries is referred to as “MSME finance.”

Most MFIs are providing household-based loan products. Some are specifically targeting women and applying group-guarantees and other social trust bonds as substitutes for conventional collateral (i.e., traditional microfinance products), as well as home improvement loans. Loan repayment among MFIs is generally quite good, and in most cases, excellent, but operating efficiency levels are low, in large measure due to the high costs of security.

#### Client Story

Ahmed\* lives in a southern Iraqi city. He has owned and operated a small iron workshop for 20 years. Ahmed is in his 50's and works hard to support his family, which includes three physically disabled children.

Ahmed learned about the opportunity to receive microfinance loans through a local loan officer. He took his first loan of \$1500 to buy a welding machine and a heavy-duty cutter. With the increased income he earned he was able to buy the shop next door and expand his business. Following successful repayment, he has received two additional loans in order to further upgrade his shop with the purchase of a larger generator and a portable welding machine.

Now he is able to create iron doors and windows instead of just joining them. His business is realizing a greater income, which has allowed him to purchase wheelchairs for his three children, which he couldn't afford because they cost almost \$150 each. He is now even planning to travel abroad to seek corrective treatment for one of his children.

\*Not his real name.

All of the MFIs face challenges not only due to an ever-changing security situation, but also by an immature policy and regulatory system, donor pressure for action and reporting, and the acquisition, training and retention of qualified personnel. In Iraq, security issues greatly affect both demand and supply of financial services. Although security is deteriorating markedly in many locations, security conditions are not homogenous across Iraq – some cities and areas are quite stable.

Microfinance is not simply banking for the poor; it is a development approach with a private sector based social mission and a financial bottom line. The key to successful financial service provision to the poor lies in the ability to cost-effectively reach a critical mass of customers with systems of delivery, market responsiveness, risk management, and controls that can generate sustainability

for the institution. Thus, two long-term goals of microfinance are *outreach* and *sustainability*. When knowledge of or attention to these good practices are insufficient, the short-term losses and the longer-term unsustainable impact of such operations ultimately harm the very clients that they were meant to benefit. Thus, when referring to microfinance and/or SME finance in Iraq, it is important to understand that the short-term outreach indicators of numbers of loans provided or their locations must be understood within the larger context of sustainability of MFIs, and more importantly, of the local microfinance industry.

Support should be aimed at promoting sustainable institutions that will remain in the community and continue to provide services, even after donor funding ceases. From the perspective of poor clients, it is the *permanent* access to financial services that is the most important consideration, as this helps them take advantage of opportunities and manage

risks, as opposed to one-time only loans, or to programs that are directed to provide services in areas where they would not normally operate (particularly due to security concerns).

## 2.3 Conflict and Post-Conflict Issues

Microfinance is not a conflict resolution tool, and international experience suggests that microfinance is not an appropriate development tool to use in what can be termed active war zones, where short-term relief and reconstruction efforts are more appropriate. In part, this is because the demand for microfinance is affected – borrowing for a business will be much less of a priority and will represent a (too) high risk for poor households caught in an active conflict. However, microfinance can be useful to help people rebuild and sustain their livelihoods, playing an important role in stabilizing and enhancing the economic abilities of affected populations. In the early phases of transition from conflict, *experience shows that efforts to build and strengthen individual retail microfinance providers yield the best results.*<sup>3</sup> (See Annex 2 for an analysis of how Iraq's conflict environment affects microfinance practice.)

In particular, security issues affect both microfinance demand and provision greatly in Iraq. Safe areas where economic activity occurs can turn unsafe overnight or in a few days, affecting the ability of borrowers to repay and lowering demand for microfinance as other issues take precedence and economic activity itself is curtailed by the security situation. Provision is affected as concerns for the safety of loan officers and MFI offices lead to a physical avoidance of dangerous areas or an inability to even get to work. There is a strong potential that an MFI will stop lending in the area as portfolio performance suffers and lives are at risk. As MFIs reduce their presence in deteriorating neighborhoods and cities, this can affect the ability to collect outstanding loans, and damages the image of permanence of microfinance in the eyes of the community.

In post-conflict environments, global experience has demonstrated that microfinance can be implemented successfully. Required environmental conditions are remarkably few.<sup>4</sup> Only three environmental conditions appear to be essential: (1) political stability, (2) sufficient economic activity that can use credit services, and (3) a relatively stable client population. In addition to these essential conditions, there are three preferred conditions. These are: (4) functioning commercial banks, (5) existence of social capital or trust, and (6) macroeconomic stability. Although security is deteriorating markedly in many locations, security conditions are not homogenous across Iraq – some cities and areas are unstable, with political, economic, and social ties disrupted, while others are considered stable and even improving.

## 2.4 The Supporting Infrastructure

The support infrastructure for the banking and microfinance industries (and the financial sector in general) includes providers of business services in the areas of training, auditing and accounting, rating services, information and communications technology (ICT), management information systems, and other areas. Much of this infrastructure in Iraq needs strengthening, so that the services required by MFIs are provided in a commercially viable manner. Currently, most business service providers are orientated towards their core clients. In the case of donors, projects are often designed to provide specific services to targeted clientele, who often are neither involved in the project formulation nor in payment

<sup>3</sup> See The SEEP Network, Progress Note No. 5, *Conflict and Post-Conflict Environments: Ten Short Lessons to Make Microfinance Work*, September 2004.

<sup>4</sup> See DAI, Technical Brief No. 4: *Environmental Preconditions for Successful Post-Conflict Microfinance*.

for the services. Business service providers therefore have little information about the current and developing demand within their customer base (i.e., the MFIs) and little contact to potential customers. Equally important, MFIs demanding business services are often unaware of the existence, contacts, areas of specialization, quality, or price of existing business service providers. While a truly commercially viable market for these services can only fully develop when distorting subsidies are phased out, a widely available and regularly updated directory of service providers, including a scoring system attained from evaluations by former customers, will go a long way toward filling current needs. Similarly, a regularly updated report by MFIs of their business services needs (for example, for training by topic, for audits following the CGAP guidelines for MFI auditing, for ratings, etc.) would enable business service providers to specialize in areas where there is a demand for services and to offer more relevant services. In turn, a focus on the long-term commercial viability of the business services community that supports the financial sector would generate sustainable jobs and help the development of the microfinance industry.

## 2.5 Interest Rates and Inflation

The Central Bank of Iraq's (CBI's) policy interest rate in Iraq has almost doubled since 2003, to 22% as of January 7, 2007.<sup>5</sup> As shown in the following table, in 2006 the inflation rate in Iraq was officially reported at 33%<sup>6</sup>, with other estimates ranging from 60% to 80%. The high inflation rate makes it difficult to build sustainable microfinance programs. To build a sustainable program, it is necessary for the MFIs to price their loans based on their full costs of financing, operations, loan losses, and cost of capital. The cost of capital varies based on the market interest rate and the inflation of a country. Experts advise that in countries where the prime rate for commercial loans is less than the rate of inflation, they should treat the cost of capital as the rate of inflation and add 3 to 5 percentage points.

**CBI's Report of Inflation Rates**

Year	Inflation Rate
2003	70.00%
2004	29.30%
2005	25.40%
2006	33.00%

## 2.6 The Banking Industry and Financial Sector

There is a financing gap in Iraq. Commercial bank lending to micro and small businesses is virtually non-existent. Demand from the core microenterprise level of informal sector businesses is not being met by current financial services providers. The need for additional investment in microfinance development and expansion is evident. To promote this development and expansion, Iraqi MFIs and practitioners, in the near and mid-term, will focus on the strategies discussed in the next sections.

The ability of Iraqi micro, small and medium enterprises (MSMEs) to access financial services is critical for development of the economy. About three-quarters of the Iraqi labor force is engaged in private sector activities, the majority of them informal sector business.

<sup>5</sup> [www.cbi.gov](http://www.cbi.gov).

<sup>6</sup> Source: [www.indexmundi.com/iraq/inflation\\_rate.html](http://www.indexmundi.com/iraq/inflation_rate.html).

The combination of poverty, lack of formal job opportunities, extremely limited banking services, and an entrepreneurial culture create intense demand for microfinance services that should remain high for the short to medium term and is likely to continue into the long-term.

## **2.7 The Legal and Regulatory Environment**

In Iraq it is imperative that donors, the CBI, and policymakers become engaged in developing the legal and regulatory environment affecting microfinance. Strengthening of the legal and regulatory environment affecting microfinance is very important for the industry to develop in Iraq. Generally<sup>7</sup>:

(t)here is a growing realization that a transparent microfinance policy environment, supported by a flexible set of laws and regulations, will discourage fraud, improve the quality of investments in MFIs, ensure operational transparency and forge critical links to the broader financial market. In the medium to long run, if microfinance is to be fully integrated within the formal financial sector, and if the needs of poor households and enterprises are to be met completely and sustainably, supportive legal and regulatory frameworks are ultimately necessary. This does not necessarily mean, however, that the development of a new set of laws and regulations designed to facilitate the poor's access to finance always represents the best use of scarce fiscal and donor resources. In many cases, this access can be significantly increased without reform of the legal and regulatory environment. In other situations, a number of conditions are not ripe for such a reform to take hold and be sustainable, and so efforts should be delayed until the initial conditions can be met.

MFIs today find it difficult to register and operate under both CPA Order No. 45, On Non-Governmental Organizations (the NGO Law), and the Company Law No. 21 of 1997 (the Company Law). The CBI in particular can play a lead role in this area, given its statutory mandates concerning microfinance that are found in Central Bank of Iraq Law of 2004, (the Central Bank Law) and the Banking Law of 2004 (the Banking Law). The support of other Ministries is needed as well. In order for microfinance to develop in Iraq, enhancing the legal and regulatory environment is a primary area of focus.

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<sup>7</sup> Iris Center and Chemonics International, *Legal & Regulatory Reform for Access to Finance, a Policy and Programming Tool*, USAID, December 2005, page 3.

## Section 3

# Iraq Microfinance Strategies

The experience of microfinance globally shows that microcredit is a compelling antipoverty development tool. The objectives of the microcredit programs in Iraq include the following:

- Increasing access to sustainable financial services by poor and low-income households, microenterprises, and larger, more established small enterprises.
- Building the capacity of MFIs to ensure operational and financial sustainability.
- Encouraging the development of businesses and services that support the microfinance industry (such as banks, auditing, and business development services).
- Enhancing the legal and regulatory framework for MFIs as part of modernizing and broadening the financial sector.

To achieve these goals, MFIs, practitioners, and other stakeholders have identified the following as their strategic areas of focus through the near and mid-term (three-five years):

1. Promoting awareness of microfinance and its benefits. This awareness-building program is focused on the client base of MFIs, donors, government officials and policymakers, and the banking industry.
2. Seeking a legal and regulatory environment that supports establishment of new MFIs and the integration of MFIs into the financial community.
3. Capacity building through training and other programs.
4. Emphasizing transparent operations with internationally accepted standards and reporting, and the use of computer-based record keeping for administrative, managerial, and evaluation purposes.
5. Supporting industry development through formal and informal networking opportunities, while ensuring that appropriate levels of information security are maintained.
6. Increasing business opportunities with the banking industry to: (i) provide MFIs with needed banking services; and (ii) promote partnering arrangements between MFIs and banks.

The following sections discuss each of these strategies.

### 3.1 Strategy 1 – Promoting Microfinance Awareness

In order for the microfinance industry to develop and grow, there should be further education and dissemination of information about microfinance. Expanding knowledge about the benefits of microfinance and its role in the development agenda is particularly needed at the client level, within the banking industry, at the CBI, and with key policymakers and GOI representatives. Colleges and universities can also support development of microfinance. MFIs and practitioners can assist in implementing this strategy (particularly at the client level), with a microfinance network assisting at other levels.<sup>8</sup>

**Client Base.** Currently, microfinance knowledge is disseminated to clients during the loan application process. Successful MFIs are ones that educate their clients not only about microfinance, but also about good money management practices for earning, spending, saving, borrowing, and investing. With this knowledge, MFI clients are better equipped to make financial choices and work toward financial goals that enhance their economic well-being. MFIs can promote their services through meetings with community and religious leaders. They can also develop alliances with nearby Small Business Development Centers that are already in operation. The SBDCs can refer potential borrowers to MFIs, and MFIs can refer borrowers to the SBDCs for training and information about successfully operating a micro or small business.

**Banking Industry.** Promoting microfinance awareness among banks and bankers is a priority for this strategy. Education of the banks and bankers about microfinance is needed to help develop the microfinance industry. While a number of bankers have a basic knowledge of microfinance, many more lack an understanding of microfinance, consider it a high-risk financial service, and are concerned about competition from MFIs. Continual dialogue with banks and bankers will help integrate microfinance into the mainstream financial community, promote linkages between MFIs and banks, and nurture a potential source of wholesale lending to MFIs.

**CBI.** There is yet little CBI interaction with MFIs, despite the Banking Law and Central Bank Law tying microfinance to the CBI. This deprives the industry of the CBI's financial, regulatory, and supervisory experience, and limits the ability of MFIs to be integrated into the mainstream financial sector. Through the Legal and Regulatory Working Group, assessments will be done on the types of CBI interventions that will best promote microfinance, and how the CBI can best be approached on these issues. In addition, other opportunities will be sought for developing the relationship with the CBI. This could take the form of donor funding for CBI officials and supervisory staff to attend regional or international microfinance conferences or training courses, or to provide technical assistance to the CBI in the area of microfinance. Less formal interventions will also be pursued, such as inviting CBI officials to MFI-sponsored events, and meetings with representatives of the microfinance industry.

**GOI Policymakers and Representatives.** Similar opportunities will be sought to engage in a microfinance dialogue with key policymakers and GOI representatives. These include policymakers in the Council of Representatives and Council of Ministers, and officials from MOLSA, the Ministry of Finance, the Ministry of Planning and Development Cooperation, and the NGO Office. A first step in this process is identifying particular individuals and advocates with whom to commence a dialogue. As with the CBI, donors could consider providing funding for policymakers and GOI representatives to participate in Sanabel events

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<sup>8</sup> Section 3.5 discusses the strategy for developing a microfinance network.

and conferences, for a regional microfinance study tour, or for participation in CGAP donor conferences. The emphasis of these types of engagements is to highlight the importance of appropriate government support for microfinance, while emphasizing the drawbacks of direct government provision of microcredit. GOI and regulatory bodies should also consider that support to microfinance initiatives can contribute to achievement of human development goals such as poverty reduction, which are in line with international agreements such as the *International Compact with Iraq*.

**Colleges and Universities.** Promoting microfinance awareness at colleges and universities can assist the industry in several ways. For example, one college professor is currently receiving CGAP certification as a microfinance trainer. Other professors could also serve as certified trainers (assuming funding is available for attending the certification courses). Colleges and universities can also help expand knowledge in areas such as accounting and auditing, finance, business management, and law, each of which are areas that support microfinance. As a start, the industry could consider engaging the business schools at three universities located in geographically strategic areas (such as the University of Baghdad, University of Basra, and Salah al-Din University in Erbil).

**NGOs and Business Development Centers.** Outreach through other organizations serving the same beneficiaries could provide benefits to both MFI and partner stakeholders. NGOs and training institutes can promote awareness among entrepreneurs about microfinance activities and how to access them locally. In a limited number of locations (currently, five), USAID-supported training institutes are actively referring eligible clients to MFIs as well as banks. Consideration must be given to security-related concerns in general, but there is potential for increased cooperation at the local level.

### 3.2 Strategy 2 – Enhancement of the Legal Framework

The key legal and regulatory issues affecting microfinance revolve around four laws:

1. The Central Bank of Iraq Law of 2004 (the Central Bank Law)
2. The Banking Law of 2004 (the Banking Law)
3. CPA Order No. 45, On Non-Governmental Organizations (the NGO Law)
4. Company Law No. 21 of 1997, as amended by CPA Order No. 64 (the Company Law)

Article 4(2) of the Central Bank Law provides that the CBI be authorized to regulate microfinance institutions along with other non-bank financial institutions. Article 3(6) of the Banking Law provides that “(a)ctivities performed pursuant to micro and small business credit access or similar grant programs by entities other than banks shall be permitted as authorized by entities exercising governmental authority”, and are exempt from the licensing, supervision, regulation, and other provisions of the Banking Law. The “entities exercising governmental authority” are the Ministry of Trade (where for-profit MFIs register) and the NGO Assistance Office (NGO Office) for non-profit MFIs.

Iraqi MFIs to date have registered as non-profit entities under the NGO Law, which legal commentators have criticized for its restrictiveness and voluminous registration requirements.<sup>9</sup> Difficulties in implementing the NGO Law have made it very difficult to organize new MFIs and operate existing ones.

There are also burdensome requirements under the Company Law and in its implementation. For example, even though 100% foreign ownership of a company is authorized, it is difficult to register a company that is not 100% Iraqi-owned. Additionally, while the 2004 amendments eliminated the registration requirement of sectoral approval (i.e., approval by the responsible Ministry), in practice such approval is still required (because the CBI does not register MFIs, for example, obtaining sectoral approval is difficult).

The legal framework could better support development of the microfinance industry and broadening and strengthening of the financial sector by removing major impediments under the NGO Law and Company Law. These include:

- Difficulties in registering a MFI with the NGO Assistance Office.
- Difficulties in registering a for-profit MFI with the Trade Ministry.
- Cumbersome reporting and registration requirements under both the NGO Law and Company Law.
- Inconsistent application of law from region to region.

Development of the industry could also be promoted with a clear mandate from the CBI concerning MFIs. Practitioners at the Summit discussed this issue and the type of mandate that would be appropriate. One alternative considered was a CBI regulation that would

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<sup>9</sup> Elbayar, *NGO Laws in Selected Arab States*, International Journal of Not-for-Profit Law, Vol. 7, Issue 4, September 2005, pages 11-12, citing Shea, *Comments on the Regulation of Non-Governmental Organizations Issued by the Coalition Provisional Authority, Order Number 45*, International Center of Not-for-Profit Law, page 1.

establish a “microfinance window” at the CBI. The regulation would provide for MFIs to be established and registered through the CBI, with special lending licenses issued to MFIs that meet the standards specified in the regulation.

Other issues dealt with include:

- Promoting sensitivity of the legal and regulatory issues affecting microfinance at the CBI and within the government;
- Expanding the base of products MFIs can offer (including savings products, equipment leasing, secured financing, and real estate lending); and
- Anti-money laundering, information sharing, and Islamic financing.

At the Summit MFI stakeholders agreed that a Legal and Regulatory Working Group should be formed to study these issues and assess the feasibility and terms of a CBI regulation establishing a microfinance window at the CBI, along with studying the most effective ways to seek adoption and implementation of such a regulation. The Working Group will coordinate with key donors, since strengthening the legal and regulatory environment can best be achieved by working with donor-supported programs. While in many countries experience has shown that legal and regulatory reform is not essential for development of a microfinance industry, in Iraq a strong initiative is needed to remove the existing legal and regulatory impediments that MFIs currently face.

### 3.3 STRATEGY 3 – Capacity Building and Training

Iraq, like most countries, is not unique in that MFIs seek training in all areas of microfinance. Additionally, with security concerns growing, there has been a brain drain to neighboring countries and high staff turnover, particularly by loan officers seeking safer environments with less public contact and better career opportunities. The highest training priorities identified at the recent Microfinance Summit in Erbil are: (1) loan officer training, (2) management training, (3) training in back office operations, and (4) training on management information system (MIS) issues. Other areas where training is needed include (not necessarily in order of priority):

- MFI growth planning and strategic development/management.
- Product adjustments and product development and marketing (for example, group lending, savings, insurance, Islamic finance, and cooperatives).
- Alternative methodologies (group lending, Islamic finance, credit cooperatives, etc.).
- Risk management, internal controls, and audit.
- Financial management, accounting, standards, and reporting.
- Corporate governance.

Staffing and human resource management needs exist in Iraq, as they exist in other developing countries, and capacity building and technical resources must be supported to develop MFIs and the microfinance industry. Ongoing training in these areas should continue in order to build sustainable microfinance institutions. Sustainability and commercial viability of microfinance training supply should be considered.

In early 2007, a cadre of eleven Iraqi trainers will complete their “training of trainers” (TOT) program and receive CGAP certification as microfinance trainers. This cadre of trainers should be available to MFIs throughout Iraq, fulfilling the need for in-country loan officer training, as well as training in other areas. New cadres of trainers should be continually developed in order to compensate for attrition due to migration or other reasons. Trainers should also be encouraged to specialize in areas of their strength and interest, in addition to ensuring the ability to deliver the range of basic microfinance topics.

The large MFIs in Iraq have existing internal on-the-job training programs, but with the completion of the TOT training, a formal training program and calendar will be implemented for 2007. This will start with the large MFIs (for their internal staff training), followed by training for staff of smaller MFIs.

There is also a need for on-the-job training for loan officers. A formal collaborative program could be developed for loan officers from less established MFIs to participate in on-the-job training opportunities at more established MFIs. Smaller MFIs and new entrants would be invited to attend training courses sponsored by a large MFI. Another form of collaborative training, in which a course or program is sponsored or presented by two or more MFIs, could also be developed.

Collaboration with the many training resources available in Iraq should be encouraged. There are several training programs available to bankers which could potentially benefit microfinance practitioners, as well as training programs through the Iraqi Union of Accountants and Auditors and various colleges and universities. There are also a number of SBDCs operating in Iraq. SBDCs provide a place where MFIs can refer staff to obtain training in a variety of topics, such as computer technology, business accounting, business

planning, and marketing (NB: MFI clients could also benefit from such referrals). They do not have the in-house knowledge and expertise needed for database management systems, IT networking, and other areas. Finally, in the long run, development of professional legal expertise related to microfinance should be encouraged.

The microfinance network could greatly assist in coordinated training efforts going forward.<sup>10</sup> Two of the large MFIs support the establishment of an Iraqi training base that can develop and provide training to microfinance practitioners.

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<sup>10</sup> See Part IX for a discussion of the strategy to develop this network.

### 3.4 STRATEGY 4 – TRANSPARENCY, STANDARDS, AND REPORTING

Transparent operations, sound data collection and management systems, and timely analysis assist the institution to accurately assess its condition and make the managerial or operational changes necessary to ensure acceptable performance. Reporting according to internationally accepted standards ensures that operations themselves reflect best practices. Reporting ensures Boards, donors, and other stakeholders that the MFI is soundly managed and meeting required performance targets, and can assist in identifying problem areas requiring cooperation to resolve.

Information submitted to funders must be easily comparable to other MFIs, in order for donors to understand the full picture of the climate, trends, and options for microfinance activity in a timely manner. This is particularly relevant in Iraq, which is a dynamic and rapidly changing environment with a very high profile for donors and policy-makers. These donors and policymakers, in turn, are inundated with frequent requests for status updates and analysis. Particularly, donors funding multiple MFIs, or comparing data across the entire industry, need to receive clear, reliable, and comparable data to fully understand strengths, weaknesses, and trends in a timely manner. Thus, strategic decisions made in Iraq, as elsewhere, can be clearly defended according to the data.

In November 2006, a unified reporting format was introduced to all USAID grantees, after extensive review and consultation. Continued reporting in this format and continued cooperation to resolve outstanding accounting and reporting issues will assist MFIs to use appropriate management tools, communicate successes and challenges clearly with donors, and assist donors to understand the broad trends in Iraqi microfinance across multiple providers.

Donors and MFIs should also work to explain and resolve any security concerns possibly stemming from reporting – ranging from difficulty collecting certain information because it will disrupt client relationships (for example, a focus on sectarian affiliation) to confidentiality of detailed information on areas of loan activity in order to avoid identification of microfinance operations, branch offices, loan officers, or clients. In order for the industry to develop, legitimate, overriding security concerns must take priority, even while donors and MFIs make a constant push towards effective performance monitoring and transparency.

Several types of indicators and types of reporting are important:

**Outreach.** Outreach indicators, such as gender, location, age, client poverty levels, etc. allow assessment of which target groups are being served. Changes in geographical indicators, such as an increasing portfolio-at-risk in an area with deteriorating security, allows clear evaluation of the effects of conflict on MFI performance and can bolster justification for MFIs that may wish to reduce activities in areas with poor security, although donors may have a particular interest in maintaining activity in those areas for other strategic reasons. MFIs and donors should be clear about performance parameters that will trigger such decisions, and which party will make those decisions. Indicators must be set in advance to allow specialized information to be collected if reporting will be required. Particular targets related to goals such as poverty reduction, employment generation, or community stabilization, should be measured by appropriate indicators, or supported by additional evaluations. Impact assessments are often conducted through periodic evaluation efforts outside the normal scope of reporting. Timeliness, scope, and cost of such evaluations should be clearly discussed and agreed upon.

**MFI Financial and Portfolio Performance.** These indicators allow the MFI to demonstrate success of particular products, successes, and risks of particular geographic areas, and the impact of security, training, travel, or administrative overhead on sustainability. This allows managers to understand their own performance and understand how best to improve.

**Expenditure of Grant Funds.** Donors must have a clear picture of the cost of operating programs. Donors need to understand the ratio of funds actually being made available or passed through to local MFI operations (versus home office costs) and thence to beneficiaries of the MFI through microfinance loans and services such as entrepreneurship or business training. This is done through review of MFI financial and portfolio indicators. Donors and grantees should also examine the impact of security costs, particularly whether they are treated as overhead, borne by the home office, or deducted from pass-through funds for Iraqi operations. This issue is particularly relevant for understanding the true costs associated with establishing Iraqi MFIs, and for allowing large MFIs to be accurately compared to smaller ones.

MFIs that are not USAID grantees should be encouraged to report the same information that was implemented in November 2006. Additionally, all MFIs should consider that achieving the type of reporting discussed above entails the following:

- MFIs must have adequate MIS systems.
- MFIs must clearly articulate what they are able and unable to produce and why (for example: limits of MIS; data requested is outside their standard procedures of what is collected; staffing or back office capabilities must be improved).
- MFIs and their donors, investors, and directors must reach a mutual understanding of the level and type of reporting that is required in order to ensure communication regarding performance and goals.
- MFIs should alert donors if various sources are requesting different information, so that donors can ensure that MFIs do not have to report in multiple formats. Where possible, MFIs should avoid preparing different reports for different donors unless there are specific, goal-driven reasons (for example, specific target group coverage required).
- MFIs must have accounting and tracking systems in place enabling them to provide clear reports on the use of funds, especially when the MFI has been funded from several sources or the grantee operates multiple projects (keeping donor funds in segregated accounts is not necessary). This is relevant for microfinance lending activities and financial performance as well as grantee home office reporting that should show clear allocation of funds for technical support, administrative overhead, and security.

Research and evaluations should also be used to gauge the success of microfinance providers in meeting the objectives of their microfinance programs. Collaborative research opportunities should be explored as ways to meet MFI and donor needs while reducing reporting burdens. It can also build the capacity of MFI staff, university students, and donor evaluation departments. These types of assessments are often favored by donors as a means to document program results. However, they are seldom of major relevance to MFI customers, who will simply choose not to continue doing business with a MFI that does not provide adequate services. Therefore, such assessments should be conducted periodically outside the normal scope of the MFI's reporting and separately funded by the donor requiring the assessment.

Standardization and transparency in reporting is very important, both for developing a sustainable MFI and for showing transparency to donors. Reporting should adhere to an internationally accepted, easily comparable format. Experienced microfinance providers should educate donors regarding what information to expect in a dependable fashion. In order to avoid changing requests and formats.

Reporting to government officials has the potential to inform the development of legal and regulatory regime, but must be accompanied by intensive education. For example, MFIs registered as NGOs must take care to define “profitability” in an environment where “NGO” is considered synonymous with “non-profit” by officials who do not fully understand the MFI mission and operations.

In a conflict or post-conflict environment, performance standards and targets may vary from best practices according to variable donor goals (e.g., rapid delivery of credit to generate employment and economic activity versus careful selection of areas of operations to ensure sustainable loan portfolio performance). MFIs should accordingly work with donors to develop appropriate indicators for reporting in Iraq’s conflict environment.<sup>11</sup>

Finally, there is a lack of external and internal audit capacity in Iraq. MFIs can work with the Iraqi Union of Accountants and Auditors to improve the environment relating to audit capacity. An external audit program for indigenous MFIs, for example, has been implemented by the USAID IZDIHAR project. In addition, audit results of local microfinance operations by large MFIs should be shared and discussed with donors.

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<sup>11</sup> This issue is dealt with further in Section 4, *A Note to Donors*.

### 3.5 Strategy 5 – Developing a Microfinance Network

Microfinance networks are informal or formal associations of MFIs that play an important role in financial sector development.<sup>12</sup> They support retail MFIs with services that improve microfinance performance, advocate for members, and build awareness and confidence in microfinance. Their roles include building awareness about microfinance, training and capacity building, and promotion of best practices. They contribute to improving the performance of MFIs through information sharing, mutual accountability, and standards setting. The table below shows some of the roles and services of microfinance networks.<sup>13</sup>

#### Roles of Microfinance Networks

Awareness building	Capacity development	Exchanging advice
Facilitating discussions	Financial intermediation	Finding expertise
Impact analysis	Information exchange & dissemination	Industry learning
Innovation	Institutional development	Knowledge creation
Media campaigns	Microfinance best practices	Monitoring and evaluation
Peer learning	News and events information	Performance monitoring
Policy advocacy	Research	Technical assistance
Training	Training of trainers	Web-based resources

Practitioners at the Microfinance Summit expressed the need for a microfinance network to help serve as an advocate, disseminate information about microfinance practices, and assist in training development. A network will also provide a unified body that represents the common interests of MFIs, improve MFI awareness of developments affecting the industry, assist in developing standards, reporting, and the compilation of market-related information, and provide other services to its member institutions.

Microfinance networks have the potential to be particularly important in crisis-affected environments. In challenging environments, some network services become even more crucial. Issues like a lack of information, uneven application of best practices, uncoordinated donor intervention, and an inappropriate policy environment are among the most pressing problems in such environments. While these issues are present in many normal situations, they tend to be exacerbated in crisis environments.<sup>14</sup> However, the difficulties created by crisis also make network functions more difficult to carry out.

Given the geographic distances between Iraqi MFIs and difficulties in travel, a website dedicated to the network was seen as a high priority. This and other efforts to share information could serve basic needs and allow Iraqi MF practitioners to develop their own vision for how to interact as a formal or informal network. Next steps should be to encourage emergence of a point-person or group to manage information dissemination (such as through the website, newsletter, or informal email communication) as well as to encourage smaller groups to become active on deliberating on and developing positions and strategies on meso- and macro-level issues.

<sup>12</sup> Annex 3 discusses in more detail the need for and role of a microfinance network in Iraq.

<sup>13</sup> Tenn, McInerney, and McAllister (Dolan and Meissner, contributing authors), *Building Strong Networks: An Institutional Strengthening Guide for Microfinance Networks*, SEEP Network, June 2006, page 7.

<sup>14</sup> Meissner, *The Role of Microfinance Networks in Challenging Environments*, SEEP Network Technical Note, October 2006, page 3.

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### **3.6 Strategy 6 – Increasing Business Opportunities with Banks and the Banking Industry**

There are two areas of focus for this strategy. The first is increasing the scope and quality of basic bank services available to MFIs. The second is exploring linkages with banks to expand the scope of microfinance outreach and activities through areas of cooperation.

Currently, the banking industry is not well developed, in part due to lack of bank competition, years of isolation from the international banking sector, and the prior regime's strong and central control over banks. This has resulted in Iraqi banks facing major challenges. Modern banking practices are seldom known or practiced. Modern banking products and services are rare. 90-95% of banking assets are concentrated in the state-owned banks. While there is strong liquidity in the banks, they are reluctant to lend to micro and small businesses, particularly given the interest rates available on CBI deposits. In addition, the use of technology in banks is limited, and the lack of a nationwide payment system makes operations difficult for MFIs, banks, and businesses.

A functioning banking system is critical to microfinance operations. MFIs need to conduct their own banking transactions. They also commonly use bank branches to collect payments from clients, which are deposited to the MFI's account. In large part, this is done for security reasons. It also aids in recordkeeping, as the bank should easily be able to generate a record of loan payments. However, MFIs in Iraq have experienced problems ranging from poor bank record-keeping to requests for bribes to release the records, to a need to bring their own paper to the bank on which the statement is written. In addition, transferring money electronically between some branches or bank accounts has its own challenges. Many banks tend to be reluctant to deal with MFIs.

The first part of this strategic focus is to increase the relationships between MFIs and their banks. This could be done by developing a series of working meetings or conferences between the senior representatives of banks and MFIs. Since the banking industry is headquartered in Baghdad, these meetings should take place there or in another suitable location. MFIs should have a clear agenda for these meetings and be able to outline their needs, address the concerns raised by banks, and seek to find acceptable solutions. One-on-one discussions with banks should be arranged with a goal of strengthening the relationship between banks and MFIs.

As part of this strategy, MFIs can seek to educate bankers on the opportunities the microfinance industry brings to banks, and on how MFIs will not take business away from banks, but instead provide additional business opportunities to banks. Because the private banks have little geographical coverage and are concentrated in the major cities, MFIs offer products typically not provided by banks (for example, the average loan size for MFI loans is typically much smaller than bank loans): this type of loan product cannot be provided by banks (in part due to the banks' higher per-transaction costs). Conversely, banks offer many products and services that are not provided by MFIs, either for regulatory reasons or because banks have the capital to develop products and systems beyond the reach of MFIs: for example, mobile phone and other information and communications technology (ICT) is typically too expensive to develop and implement by MFIs alone. Annex 4 discusses this and other ICT issues.

The second part of this strategy focuses on these differences between MFIs and banks, and the new business opportunities for banks that develop linkages with MFIs. As the microfinance and banking industries develop, several types of linkages can be considered. Some of these are discussed below.

**Loan Capital Financing.** Banks are potential wholesale lenders that can provide MFIs with loan capital. Indeed, part of the focus of this and the first strategy is to increase the awareness of banks about microfinance so that banks can indeed consider wholesale financing for microfinance providers.

**Use of Mobile Phones and Other Technology.** The use of mobile phone technology can allow financial services to be offered even in high-threat environments. ATMs are another type of technology that can provide greater access to financial services, particularly in areas where banking services are not available. Since the IT infrastructure costs for these types of services are beyond the reach of most MFIs, they can make contractual arrangements with banks to develop and offer these services.

**MFI-Bank “Partnership Model”.** In this model, the unique innovation is that the MFI evaluates, recommends, originates the loans, helps in disbursement and subsequently tracks and collects the loans for a fee. However, the loans sit on the books of the bank and not of the MFI, and the bank assumes all credit risk. This model limits the need of the MFI to acquire additional loan capital, and eliminates the double credit exposure the bank would have with a loan capital credit extended to the MFI.

**Bank “Outsourcing Model”.** Banks may find it more efficient to outsource various non-financial support functions to MFIs. These may include: (1) identification of borrowers, (2) collection of applications and verification of primary information/data, (3) preliminary appraisal of credit based on standard norms set by banks and using local data/information (a simple credit scoring model may be employed), (4) marketing of the financial products including savings / providing product information, (5) processing and submission of applications to banks, (6) post-loan monitoring; and (7) follow-up for recovery.

**MFI “Outsourcing Model”.** This is similar to the bank outsourcing model, except the MFIs outsource various back-office functions to banks. This model is currently practiced by several MFIs that use banks for loan disbursements, payment collections, and other functions.

**MFI-Bank “Correspondent” Model.** Under this type of linkage, the MFI acts as an agent for a bank providing (in addition to the support functions described above) various financial functions on behalf of the bank, such as: (1) disbursement of small value credit, (2) recovery of principal / collection of interest, (3) sale of other bank products and services, (4) collection of small deposits, and (5) receipt and delivery of remittances and other payment instruments. Since MFIs currently cannot accept deposits, the MFI Correspondent model would provide a good opportunity for MFIs to expand their products by offering their customers the ability to establish savings accounts.

**ICBG.** The Iraqi Company for Bank Guarantees, Ltd. (ICBG) is an Iraqi non-bank financial institution that provides partial loan guarantees on SME loans made by its participating banks. The microfinance industry should consult with ICBG about developing a guarantee program that would support loan capital financing for MFIs. For example, an ICBG guarantee on a loan made to a MFI could help reduce the degree of credit risk perceived by the lending bank. Additionally, armed with an ICBG guarantee, a MFI seeking loan capital could shop among several banks to determine the most favorable terms.

Besides facilitating wholesale lending to MFIs, ICBG can help facilitate development of the microfinance industry:

- Many of its training programs it currently provides to banks and bankers would be appropriate for MFIs and MFI management and staff.

- ICBG itself, with a large percentage of Iraqi banks participating in its guarantee programs, could help facilitate business dealings between MFIs and banks.

When working with banks, MFIs must remember that: (1) some banks will be more receptive than others will; and (2) banks have varying financial strengths and capabilities. These factors should be considered when developing business relationships with banks. Such relationships, though, will allow both banks and MFIs to generate additional sources of income, expand access to financial services, and help broaden and strengthen the financial sector.

In addition to increasing business opportunities with banks, MFIs should expand outreach by linking with providers of business development services, other NGOs, and self-help groups (SHGs) that meet agreed standards of operation. Repayment rates, sound operating and financial structures, and competence in expanding outreach should be among the factors considered by MFIs when evaluating NGOs for this purpose.

Finally, microfinance services are not limited to enterprise credit but can cover all a wide variety of services offered to poor households. These including credit, savings, insurance, consumption loans, housing loans, remittances, and other types of products. The vast majority of poor households would benefit significantly from access to savings accounts and appropriate micro-insurance services, including in particular medical, life, property, livestock, and crop (price index) insurance.

In addition, customers in unstable or remote areas that are less linked to formal markets typically need better access to *non-financial services* to improve their businesses, including training in business and financial management; vocational/ production-related training and transfer of new/improved technologies; market access, market information and communication, etc. Developing linkages with the existing SBDCs established through IZDIHAR is a specific means for providing these services to MFI customers.

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## Section 4

# A Note to Donors

### 4.1 Current Donors and Their Objectives

Current in-country donors supporting microfinance include USAID, IRMO, and DfID, while the World Bank and the UN have expressed interest in supporting microfinance. Donors have diverse goals for choosing to support microfinance as a strategy. Worldwide, these goals have primarily included poverty reduction, often with an emphasis on providing financial services to women. In Iraq, specific goals also include job creation and spurring local economic and private sector development (in part to meet larger objectives such as improving stability). The assumptions for using microfinance as a strategy to meet these goals must be openly discussed among all stakeholders so that various partners understand the others' objectives, and to match funding and operational strategies to ensure achievement of disparate goals. If possible, coordination of donor agency activities in microfinance has the potential to enhance economies of scale and promotes learning. At a minimum, donor cooperation and clear communication with microfinance providers can identify appropriate interventions, avoid duplication of funding and conflicting interventions, and clarify variances in areas and methodologies that different donors choose to support.

Particular goals and target groups include:

- Poverty reduction through targeting poor households;
- Economic development through targeting sustainable local businesses;
- Job creation to promote stability and defeat the insurgency through a focus on unemployed young men in conflict areas;
- Reduction of poverty and gender disparity through a focus on women; and
- Poverty reduction or improved economic activity through a focus on rural areas and agriculture.

Additionally, according to the priority of the donor, microfinance operations have had a focus either on rapid delivery of services in targeted communities, or on building sustainable operations for long-term success. The international organizations have largely tended to resist providing directed services in areas that are not stable, evidencing a preference for focusing on building sustainable operations. Often the same donor will express an interest in both aspects of microfinance development.

An emerging paradigm in Iraq is the use of microfinance by some donors as an intervention to promote economic development, contribute to local stabilization and job creation, and thereby mitigating conflict. The target group for this activity is unemployed young men. This focus has the potential to conflict with other donor programs: for example, those that focus on the provision of services to women. All parties must clearly understand what performance and outreach measurement will be given priority, or at a minimum, will be of concern to the particular donor, and the impact of these programs on the overall development of the microfinance industry. Donors may also wish to explore other alternatives besides microfinance (for example, cash-for-work) that may be a better fit with this and other specific objectives.

## 4.2 Donor Strategies

Donors should communicate with microfinance providers about three key issues. The first issue involves donor “exit strategies,” the second involves expansion and outreach, and the third addresses the geographic areas in which MFIs operate.

**Exit Strategies.** One aspect germane to the effort to build a sustainable Iraqi microfinance industry has been an emphasis (often a requirement of grant funds) on establishing an Iraqi-registered entity. One large MFI has accomplished this while two others have been unable to do so. Registration is legally difficult in the current legal and regulatory environment. Donors and microfinance providers should discuss whether “spinning off” a separate, Iraqi-registered MFI is a preferred exit strategy, including what are the pros and cons, and what are the costs, level of required mentoring, training and assistance, and the appropriate timeframe, given that in the microfinance industry globally (the majority of which operates outside conflict areas), new MFIs take on average five to ten years to achieve financial and operational self-sufficiency. Stakeholders should examine this and other options, particularly considering the legal and regulatory environment, and be flexible.

**Expansion.** The current emphasis on microfinance is putting tremendous pressure on existing microfinance providers and related institutions to expand operations. Expansion should be considered along with the chosen exit strategy and the long-term plans of the grantees. In particular, expanding microfinance operations requires investment in training, increased management attention to performance and financial sustainability, and provision of additional sources of funds in the case where the desired expansion is more rapid than that allowed by the organic growth of the institution. New sources of funds may be from donors, investors, or new products such as savings. As noted, “(f)or financial service providers to the poor to reach significant numbers, they need to be able to intermediate between domestic savers and borrowers, as donor funds have neither sufficient scale nor stability to support massive growth”.<sup>15</sup>

**Geographical Requests for Coverage.** One particular aspect of expansion deserves to be discussed explicitly. This is when expansion is being requested along geographical parameters, such as a request to offer microfinance in conflict-prone areas. Experienced PVOs/NGOs with a focus on sustainability are unwilling to enter such areas, since this potentially creates a direct threat on the lives of staff and the security of the institution. There is also a feeling that the outbreak of violence negatively affects portfolio performance. However, microfinance has been able to operate in other conflict environments.<sup>16</sup> Care must be taken to separate expectations for these portfolios from other expectations. Where partnership with a longer-established program or international provider is the preferable or only possible solution, options to be examined include segregation of funds, development of clear policies and procedures to avoid security threats, and use of extension officers whose affiliation with the larger entity is kept confidential or low-profile). Another option is to develop new Iraqi MFIs that explicitly understand that provision of microfinance services in these areas is a core part of their mission. In this scenario, less-experienced microfinance providers are asked to produce results in a demanding environment for even more-experienced MFIs, so supporting such institutions through mentoring, training, and careful analysis of operations and results is critical. Other options for expanded geographic coverage include:

- Mentoring/partnering with a more experienced MFI.

<sup>15</sup> Helms, *Access for All: Building Inclusive Financial Systems*, CGAP, 2006, page 1.

<sup>16</sup> Annex 2 discusses in more detail microfinance activities in a conflict environment.

- Use of outreach/extension officers, with careful attention to the relationship between the loan officer and the MFI's headquarters, and considering the relationship between the loan officer and the clients. Back-office support can be facilitated through use of email, secure web sites, and double-blind transactions.
- Segregation of portfolios through development of a new "product", or through separate reporting for MFI activities in conflict areas.

### 4.3 Recommendations for Donors

In order for an inclusive financial sector to contribute to the overall goal of poverty reduction, it is important to invest in the MFIs serving the BOP to ensure that their technical skills and systems of delivery are sound, safe, and strong enough to meet the demand for credit and other financial services as it increases over time. This means maintaining a high portfolio quality (PAR of less than 5%), and attaining financial self-sufficiency (being able to cover all real and indirect costs of operations by income earned from the operations). To do so, financial services providers need to expand their customer base to a sustainable scale, while strengthening their systems. To reach substantial scale and attain sustainability, retail financial service providers need appropriate packages of funding including grants, loans and technical assistance to improve their capacity to manage growth, risk and product development while expanding their customer base at a feasible rate (Annex 1 discusses this issue in more detail).

**1. Clearly define and understand what is implied by "microfinance" in Iraq in discussions with implementing partners, in coordination with other donors and projects, and in the context of impact on microfinance operations and strategies.**

- Engage in dialogue with MFIs about the *Iraq Microfinance Strategy*.
- Understand which donor goals are well served by microfinance, and which donor goals may require a different intervention (such as cash grants).
- Match microfinance strategies to donor goals pertaining to target groups and geographical areas, and understand the challenges germane to that particular configuration. This is especially important for multi-donor programs.
- Carefully design multiple-donor programs, particularly if these programs have objectives, implementation methods, and expected results that vary from the norm.
- Clarify sources and restrictions on donor funds, particularly grant funds from USAID and other parts of the US government.
- Examine exit strategies.
- Examine MFI growth strategies.
- Agree with MFIs on risk management and performance targets.
- Develop methodologies that will allow indirect links (rather than direct linkages) between MFIs and various stakeholders in light of security concerns
- Devise creative funding and oversight methods with a small donor footprint.
- Share information such as economic development plans for focused cities and provinces.

- Consider alternatives and feasibility for an apex institution that supports microfinance with wholesale lending facilities and by promoting best practices. The ICBG, for example, should be considered for this role.

## **2. Assist in raising awareness of microfinance**

- Take care not to undermine the “culture of credit” by conducting operations that will negatively affect prudent lending practices in the microfinance industry.
- Communicate with GOI and each other to ensure that programs compliment rather than undermine each other. For example, a wide-scale low-interest loan program recently considered by MOLSA had the potential to undermine MFI operations throughout the country. On the other hand, coordinated programs offering grants to new business, with access to finance available through MFIs, may have even greater impact on these communities.

## **3. Assist in resolving legal and regulatory issues**

- Donors have a unique relationship with the GOI which should be leveraged to encourage legal and regulatory reform on behalf of the industry, in areas such as licensing, registration, and oversight. An industry association could articulate a preferred platform, which donors then could advocate with GOI.

## **4. Provide or support training**

- Provide technical assistance, strategic advice, and training.
- Provide support to encourage new MFIs and a competitive environment.

## **5. Set and adhere to clear reporting and information-dissemination guidelines**

- Agree on reporting requirements, schedules, and dissemination of information to reduce reporting burdens on MFIs.
- Encourage MFI transparency and compliance with the new standards and reporting policy and forms. Ensure clear communication of key metrics relating to outreach, performance, and use of grant funds as these inform potential for sustainability and expansion.
- Understand that high turnover and changing points of contact are an additional challenge in Iraq that has the potential to cause a lack of continuity, disruption of institutional memory, and frustration among all parties. Particular effort should be made to document discussion of strategic discussions and decisions, especially when this affects long-term planning and operational strategies.

## **6. Support networking among the Iraqi microfinance community and globally**

- Support network development through technical assistance and provision of travel and training budgets.

## **7. Support bank linkages and expanding services related to microfinance as the microfinance industry continues to evolve under extremely challenging circumstances**

- Consider networking to take advantage of synergies between various programs, such as business service training, linkages with banks or other sources of MFI funding, vocational training, and job boards.

## Section 5

# Implementation and Fulfillment of the *Iraq Microfinance Strategy*

The table below sets out how the *Iraq Microfinance Strategy* will be implemented and organized, with suggestions for activities for various parties to implement, and a rough timetable (short-term – less than one year; medium-term – one to three years; long-term – longer than four years). It is important to note that even while this strategy is focused on the medium- and to a lesser extent the short-term, achievement of long-term results relies on commencing planning and implementation in the nearer terms.

**Table 6.1 Implementation and Organization**

Strategy	Implementation	Timetable
<p>1. Promoting Microfinance Awareness.</p>	<p>MFIs should develop appropriate outreach methods according to their familiarity with the communities in which they work. Donors can assist in policy, legal, and regulatory-related education. Organizations contributing to PRT staffing should serve as a source of education to PRTs as to what the microfinance providers can or cannot do. MFIs should pro-actively respond to the challenges or opportunities provided by the PRT structure.</p> <p>An Iraqi microfinance network could help form an advocacy platform, as well as develop standard microfinance education materials.</p> <p>Raising awareness can be a low-cost activity, achieved through well-constructed meetings and distribution of succinct information. Occasional multi-stakeholder events can also be extremely useful although each requires adequate budget and planning (recommend continuation of the annual Summit, supplemented by roughly quarterly meetings of working groups).</p>	<p>Short-term: Donors and MFIs communicate about potential developments such as PRT programming, introduction of new USAID programs that could be coordinated with MFI activity, and guidelines for partnering with MNF-I civil affairs officers regarding offering MF services in conflict areas.</p> <p>Encourage establishment of a donor working group specifically focused on microfinance.</p> <p>Medium-term: Maintain accurate documentation of discussions and decisions to preserve continuity; ongoing effort to educate and disseminate information.</p> <p>Long-term: Policy advocacy efforts will become important.</p>

Strategy	Implementation	Timetable
2. Enhancement of the Legal and Regulatory Framework.	<p>Legal and Regulatory Working Group will assess alternatives and priorities for enhancements to the enabling environment.</p> <p>Donors and other stakeholders asked to help sensitize government officials and CBI on microfinance and the need to create a supportive legal and regulatory environment.</p> <p>Appropriate technical assistance should be offered, and momentum should be encouraged.</p>	<p>Short-term: Continue dialogue among implementing partners at upcoming meetings and through circulation and discussion of this <i>Strategy</i>.</p> <p>Medium-term: Continue monitoring legal and regulatory developments, identify key GOI stakeholders and donors, and formulate an advocacy strategy.</p> <p>Long-term: Develop process for enhancing legal and regulatory environment; continue monitoring legal and regulatory issues.</p>
3. Capacity Building and Training.	<p>Large MFIs continue internal training. Continue seeking USAID support for external training courses for practitioners (such as CGAP courses and international events). Cadre of CGAP-certified Iraqi trainers used to provide high quality, low-cost in-country training.</p> <p>Large MFIs should develop travel and training budgets. Continuation of Iraqi TOT program may have high initial costs, but ensure a cadre of CGAP-certified trainers.</p>	<p>Short-term: Continue TOT and other training.</p> <p>Medium-term: Support specialist or international events as necessary. Support mentoring between institutions.</p> <p>Long-term: Support Iraqi training capacity by increasing supply as well as ensuring incentives for trainers.</p>
4. Transparency, Standards, and Reporting.	<p>USAID grantees now have an agreed-upon reporting format. Audit results should be shared. Impact evaluations should be organized and implemented.</p> <p>Donors should minimize <i>ad hoc</i> and urgent requests for information as this can be extremely disruptive.</p> <p>On-going reporting is low-cost for institutions with advanced MIS. Investment in quality MIS for new MFIs to be supported. Evaluations should be budgeted and planned</p>	<p>Short-term: Continue on-going reporting according to the new format.</p> <p>Medium-term: Donors analyze trend data across implementers; conduct evaluation.</p> <p>Long-term: Development of alternative benchmarks for operations in adverse Iraqi security conditions, such as time horizons to achieve financial self-sustainability or loan loss provisioning for portfolios in conflict areas.</p>

Strategy	Implementation	Timetable
<p>5. Developing a Microfinance Network.</p>	<p>Provide technical assistance to interested Iraqi practitioners. Form relationships with regional and worldwide networks. Develop an advocacy platform.</p> <p>Donors can support membership costs and costs of attending key international events. MFIs can explore low-cost ways to communicate.</p> <p>A network can jointly develop Iraq-specific benchmarks and standards, which then enable development of a performance monitoring &amp; evaluation framework.</p> <p>Conduct outreach with NGOs, Universities, Business Development Centers, and other potential business support partners to raise awareness of microfinance, industry business needs, and potential to leverage services to clients.</p>	<p>Short-term: Encourage information sharing, establish a web-based communication vehicle (website or email distribution list), and identify a key entity to maintain information flow.</p> <p>Medium-term: Encourage the microfinance community to discuss common issues and interact with international networks.</p> <p>Long-term: Provide funding to support development of demand-driven formal network.</p>
<p>6. Increasing Business Opportunities with Banks and the Banking Industry.</p>	<p>Donors assist in improving bank services for MFIs and communicating these needs to banks.</p> <p>MFIs and banks to explore suitable arrangements.</p> <p>Improving bank practices may be costly and take time. Other arrangements between MFIs and banks should result in significant economies of scale.</p>	<p>Short-term: Engage in dialogue with banks.</p> <p>Medium-term: Explore and test linkage arrangements.</p> <p>Long-term: Improve banking system; establish and evaluate various MFI-bank relationships that may develop.</p>

## Section 6

# Conclusion

Microfinance practice in Iraq is unique. Effectively developing microfinance in Iraq requires donors, practitioners, policymakers, and others to understand what is implied in Iraq by the term “microfinance”, particularly given the challenging circumstances that exist at present.

The six strategies forming *The Iraq Microfinance Strategy* take these considerations into account. Iraqi MFIs are encouraged to reflect the six strategies in their organizations and operations. The *Strategy* itself will be circulated to microfinance stakeholders, including regional and international networks, key practitioners, and others. Since funding and sources of loan capital are an issue in Iraq (as well as MFIs globally), it will also be circulated to key donors. Selected Iraqi banks, key government officials, and others will receive the *Strategy*.

The first strategy promotes microfinance awareness and knowledge sharing. Microfinance is relatively new to Iraq, and development of the industry will be promoted by increasing basic knowledge about microfinance and awareness of the benefits it brings.

The second strategy notes that it is essential for the existing legal and regulatory to be improved in order to develop the industry in Iraq. Donors and key stakeholders in particular are asked to promote changes in the legal and regulatory environment.

Training needs are a priority for MFIs in most countries; the third strategy recognizes this is particularly so in Iraq. The need to develop best practices in a new industry, and to ensure long-term sustainability of MFIs, are only two of the reasons why training needs are vital.

Ensuring transparent operations and implementing uniform and internationally accepted standards and reporting are the fourth strategy. This strategy emphasizes the importance of MFIs communicating their successes, identifying their challenges, managing risks, and developing their relationships with donors, stakeholders, and others having an interest in Iraqi microfinance.

An informal microfinance network will underpin development of a sustainable microfinance industry in Iraq, and is the fifth strategy. This strategy focuses on developing an informal microfinance network that will advocate for reform and promote development of the microfinance industry by promoting training, MFI reporting, and standardized reporting to enable performance monitoring

The sixth strategy focuses on developing bank linkages. It focuses on enhancing the delivery of banking services to MFIs, as well as on ways to develop relationships between MFIs and banks and MFIs that are beneficial to both.

## ANNEX 1

# Background for the *Iraq Microfinance Strategy*

As in most countries affected by conflict, the Iraqi economy consists of a vast number of micro, small, and medium enterprises (MSMEs) and informal sector activities are the main source of livelihood for the majority of people. Lack of capital is a serious constraint to micro and small business development, people lack savings and may be indebted, and formal banking services are very limited. Developing MSMEs is seen by many as a solution for much needed job creation and reconstruction, and small-scale credit (loan sizes of \$500 – \$3,000 loan), often referred to as “microfinance” is seen as a means by which to ensure this development. The discourse for developing financial services in Iraq has so far attempted to deal with the entire market segment of MSMEs, using the enterprise as the unit of analysis, rather than the poverty level of the individuals who own these firms.

It is worth clarifying that the term “microfinance” is used to describe an industry that addresses different objectives and target customers than what can be more broadly construed as “SME finance.” SME and microfinance respectively require different operational and delivery systems to support the development of two distinct segments of the market, with microfinance focused on improving *household* income through provision of credit usually for business activity (but also for home improvement, etc), while SME finance focuses on the *enterprise or business*. Each requires specialized skills and capacities, and it is crucial that the appropriate evaluation instrument is selected to address the stated objectives of the program(s) in order to ensure clarity, relevance, and results-orientation in implementation. If employment generation is the objective, SME finance is an appropriate vehicle. If poverty reduction is the aim, microfinance provides a true and tested development tool, when based on good practices. The *Strategy* seeks to provide a deeper understanding of microfinance as a distinct sub-segment of the much broader MSME framework and to provide a basis for a policy-level consensus on the business, prospects, and contributions of microfinance in Iraq’s economic development.

## Microfinance – a Poverty Reduction Tool

Poor people, especially women, can contribute to wealth creation and improve their own quality of life if they start, maintain, or grow a small business. When poor people do not participate in self-employment or seek to employ others, economies waste human capital and governments incur great expense in supporting poor, dependent populations. However, poor people often lack the capacity necessary to become economically independent and they cannot fully access societal resources to help in attaining this goal. Poor people are often under-educated, inexperienced in business, in poor health, isolated in rural villages or urban slums, or discriminated against because of religion, ethnicity or gender. Poor people also often lack access to the capital necessary to drive existing or potential businesses, for want either of personal assets or collateral, or of financing from friends, family, or acquaintances willing to invest. As such, financial services from banks or other formal financial institutions typically elude poor people. This is the background for microfinance – specialized financial services for the poor segment of the population – the Bottom of the economic Pyramid (BOP).

Globally, microfinance is defined as the provision of financial services for poor households and the enterprises they run to sustain their livelihoods. Good practice microfinance targets economically active poor households, who cannot access financial services from regular commercial banks and other formal sector providers, be it for socio-cultural, systemic, geographical, or other reasons. Microfinance thus serves the economic unit of the *household* as opposed to commercial banking serving an enterprise, as micro enterprises (on- and off-farm) are usually embedded in a dynamic household economy where resources are allocated in response to situational changes and fungible of cash within and between household and enterprises is vital.

Financial services enable the poor to increase and diversify incomes, build human, social, and economic assets, and to move from everyday survival to planning for the future: they invest in better nutrition, housing, health, and education. Microfinance often specifically targets women. Comprehensive impact studies have demonstrated that: (i) microfinance helps poor households meet basic needs and protect against risks; (ii) the use of financial services by low-income households is associated with improvements in household economic welfare and enterprise stability or growth; (iii) by supporting women's economic participation, microfinance helps to empower women, thus promoting gender-equity and improving household well-being; (iv) for almost all significant impacts, the magnitude of impact is positively related to the length of time that clients have been in the program<sup>17</sup>.

From the perspective of poor clients, it is the *permanent* access to financial services that is the most important consideration as this helps them take advantage of opportunities and manage risks, as opposed to 'one-off' loans or 'stop-and-go' credit available as and when supply-led institutions succeed in raising external capital. The chief motivation among BOP customers for repaying a loan is the promise of future access to more and larger loans and this is often re-enforced with social collateral such as group guarantees. This explains why microfinance can operate successfully in the informal sector without physical collateral, enforceable contracts, and commercial courts, and provides the background for the typically excellent repayment rates among the poor. The laws of microfinance are embedded in good operating practices and re-enforced by social contracts.

## Demand and Supply of Microfinance Services

Microfinance services are not limited to enterprise credit but can cover all financial services offered to poor households, including credit, savings, insurance, consumption loans, housing loans, remittances, and other types of financial products.

Poor people can, do and want to save, and when they do not save, it is because of lack of opportunity rather than lack of capacity. Over time, savings can grow to build assets for investments. The purpose of micro-savings services in an inclusive financial system is to provide poor people with a safer alternative to the informal savings mechanisms that are often high risk. Thus, every household will benefit from access to savings.

Remittances are also a crucial financial service for a growing number of BOP households, especially in areas affected by conflict leading to displacement and temporary flight, e.g. for families of income earners and business owners having relocated from Iraq. Many families depend on reliable and convenient access to points of receipt of contributions from distant work places. The vast majority of poor households would also benefit significantly from

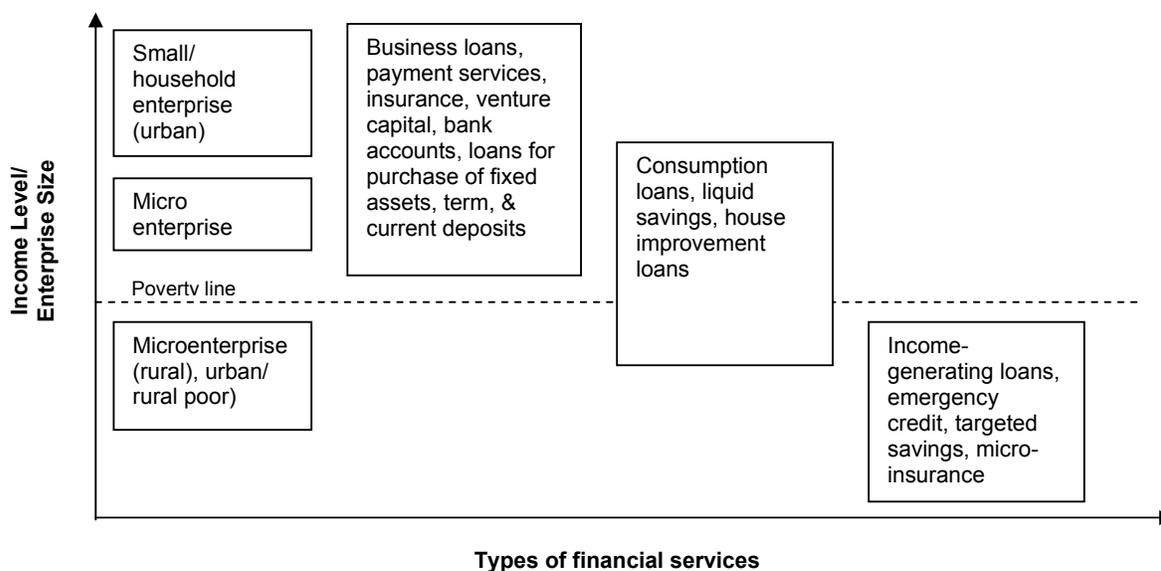
<sup>17</sup> The G8 and CGAP endorsed 11 key Principles of microfinance: Key Principle 2, found at: [www.cgap.org/keyprinciples.html](http://www.cgap.org/keyprinciples.html). See also CGAP Donor Brief No. 9, December 2002: *Microfinance and the Millennium Development Goals; and Clients in Context, The Impacts of Microfinance in Three Countries*, Assessing the Impact of Microenterprise Services (AIMS), USAID, January 2002 ([www.mip.org](http://www.mip.org)).

access to appropriate micro-insurance services, including in particular medical, life, property, livestock and crop (price index) insurances.

By contrast, credit is *not* an appropriate or desirable financial product for everyone. Without an income generating household activity, credit can over-indebt households, making them poorer. Demand for credit should not be confused with the general demand for 'money' among the poor to fulfill their basic consumption needs – nor with the number of 'eligible households'. Among the very poor, the loan demand and borrowing against future savings (repayments) need to remain within the savings capacity of the households, which is limited and varies over time. Because of the difficulties in managing this cash flow, high-value and long-term credit is not very desirable, and the very poor seldom demand increased loan sizes at a regular interval<sup>18</sup>. However, if cheap (subsidized) credit is easily available, even very poor households will often be tempted to take more credit than they would at market rates – and more than they may be able to afford. Micro-credit is thus most appropriate where ongoing local economic activity generates sufficient household cash flow, and borrowers use loans to *grow* a profitable business or productive activity, i.e. an activity that actually produces an income in surplus of the investment costs, rather than to establish a new enterprise.

Demand for the design and structure of financial services - credit in particular - varies with the type and location of the enterprises in which the customers engage. For example, a rural crop producer and an urban petty trader will have very different demands. While a small loan can certainly make a significant impact in raising the income-generating capacity of a rural poor household, urban households and micro-enterprises have different characteristics and hence different needs, as illustrated in Figure 2.1:

**Figure 2.1. Demand for Financial Services among BOP<sup>19</sup>**



Micro and Small Enterprises (MSEs) are generally more labor- than capital-intensive and have high relative production costs (because raw materials are purchased in small

<sup>18</sup> For a differentiation of demand for loans, see Simanovitz, *Microfinance for the Poorest: A Review of Issues and Ideas for Contribution of Imp-Act*.

<sup>19</sup> Mai lan le & Nhu An Tran, *Entering a New Market: Commercial banks and Small/Micro Enterprise Lending in Vietnam*, ILO Vietnam Working Paper Series No. 3, 2003.

quantities). They lack technical experience in production, accounting, administration, and stock control (due to low levels of qualification). Most of them are unregistered (or partially registered) and family-based, and most MSEs start up without any institutional help. The entrepreneur usually obtains the small amount of finance he needs from his own savings or from his family. However, MSEs find it difficult to grow without the possibility to borrow additional capital. Formal credit providers are often reluctant to lend to MSEs and the informal markets that replace them typically lend at rates that may jeopardize their survival.

Financial service providers thus need to adapt their services to each market segment in order to meet these diversified needs. Standardized approaches and loan products based on donor requirements, ease of management and delivery constraints do not necessarily meet the market demand, but demand-driven design, adaptation and product development requires a level of specialization and expertise that is in short supply among the microfinance providers in Iraq.

Customers in unstable or remote areas that are less linked into the market also typically demand better access to complementary *non-financial services* to improve their businesses, including training in business and financial management; vocational/ production-related training and transfer of new/improved technologies; market access, market information and communication, etc. There is a large and often unmet demand for high-quality Business Development Services among BOP customers. Finally, increased stability, security and market development in Iraq continues to be a necessary ingredient in the fight against poverty.

## **Provision of Microfinance Services in Iraq**

Microfinance can contribute to overall economic development in Iraq through poverty reduction (for example, employment generation for which SME finance is key), as a specialized methodology of ensuring access to demand for financial services by the poor segments of society excluded from conventional banking, and by helping them increase their income levels, build assets, and reduce their vulnerability in times of economic stress. Microfinance is not simply banking for the poor; it is a development approach with a private sector based social mission and a financial bottom line. The key to successful financial service provision to the BOP lies in the ability to cost-effectively reach a critical mass of customers with systems of delivery, market responsiveness, risk management, and controls that can generate a profit to the institution. Typically, this profit is ploughed back to ensure the long-term survival of the institution, i.e. the continuous provision of services demanded by its clients. Thus, the two long-term goals of microfinance are substantial outreach and sustainability. When knowledge of or attention to these good practices are insufficient, the short-term losses and the longer-term unsustainable impact of such operations ultimately harm the very clients that they were meant to benefit.

Microfinance has largely developed outside the realm of the formal financial sector, as a specialized industry targeting a relatively narrow range of clients with separate standards and techniques, spearheaded by NGOs. All poor and low-income people, not just entrepreneurs, use and need financial services, and NGOs have neither systematically reached massive scale nor become independent of donor funding, although there are major exceptions. Institutions with large infrastructures, such as commercial banks, credit union networks, and financial cooperatives could play a significant role in scaling up financial services to the Bottom of the Pyramid (BOP). Only if financial services to the BOP are integrated into the overall financial systems can large-scale sustainable service delivery mechanisms be achieved. Inclusive finance describes the sector-wide development strategies that open the financial services markets to increasingly poor and geographically

remote customers while integrating the providers of sustainable microfinance into the formal financial sector to allow more access to capital, better protection of poor people's savings, and increasing legitimacy and professionalism of the microfinance industry, without compromising its social mission<sup>20</sup>.

In order for an inclusive financial sector to contribute to the overall goal of poverty reduction, it is important to invest in the MFIs serving the BOP to ensure that their technical skills and systems of delivery are sound, safe, and strong enough to meet the demand for credit and other financial services, as it increases over time. This means maintaining a high portfolio quality (PAR of less than 5%), and attaining financial self-sufficiency (being able to cover all real and indirect costs of operations by income earned from the operations). To do so, financial services providers need to expand their customer base to a sustainable scale, while strengthening their systems. To reach substantial scale and attain sustainability, retail financial service providers need appropriate packages of funding including grants, loans and technical assistance (TA) to improve their capacity to manage growth, risk and product development while expanding their customer base at a feasible rate.

The types of strategies used to promote microfinance are often very different from those for promoting small and medium enterprise development. To reach the poor, institutions need to utilize alternative forms of collateral, place outlets in locations where the poor reside and structure products that are in line with the needs of this market segment. While some banks have been able to downscale in order to achieve a lower income market segment, few banks are as able to reach as far down as NGOs. NGOs have thus been the primary intermediary for reaching the poor. A policy dialogue aimed at supporting the development of the microfinance industry must address the barriers that currently exist which limit NGO's capacity to grow and provide a broader array of financial services to their clients.

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<sup>20</sup> See CGAP Donor Brief no. 11, March 2003.

## ANNEX 2

# Microfinance in Areas Affected by Conflict

Microfinance can play a crucial role in helping people affected by conflict rebuild and sustain their livelihoods. Microfinance can help such people invest in enterprise activities, meet emergency needs, reduce vulnerability, and build assets. When good practice is applied, supporting microfinance in the early phases of post-conflict stabilization and reconstruction can provide an effective means of both providing direct support to some of those most affected by conflict and laying the foundations for building permanent local financial institutions that will serve the poor for the long-term.

Based on lessons learned from a number of recent and ongoing conflicts around the world, the Consultative Group to the Poor (CGAP) has compiled a set of 'essential' and 'preferred' preconditions for successful microfinance in areas affected by conflict, as described in Figure 1:

**Figure 1. Preconditions for Microfinance<sup>21</sup>**

Preconditions for Microfinance in Conflict Areas	What does this mean?
<b>1. Essential external preconditions:</b>	<b>Min. 2 of 3 should exist before MF is attempted</b>
Minimum political stability and security	Microfinance is not a conflict resolution tool. Program areas must offer a reasonable degree of security and safety for clients and MFIs to carry out their activities. Focus efforts in pockets of stability when other areas of the country remain inaccessible.
A stable population	Maintaining timely loan recovery is difficult with mobile populations. Focus on residents, internally displaced people, and returnees, rather than refugees; include returnees.
Sufficient economic activity and a cash economy	Microfinance allows clients to take advantage of economic opportunities - it does not create them. People need access to productive resources, be able to trade, and carry and use money for microfinance to work.
<b>2. Preferred external preconditions:</b>	<b>Min. 2 of 4 should exist before expanding MF</b>
Functioning government and enabling legislation	Provides clear "rules of the game" to MFIs.
Functioning commercial banking sector	Supports MFI operations.

<sup>21</sup> Bruett, Larsen, Nourse, and Tucker, CGAP Donor Brief No. 21: *Supporting Microfinance in Conflict Affected Areas*, December 2004; see also DAI, Technical Brief No. 4: *Preconditions for Successful Post-Conflict Microfinance*.

Social capital/trust and skilled workforce	Supports business environment.
Macroeconomic stability – absence of hyper inflation	High inflation makes it difficult to build sustainable microfinance operations. MFIs must price loans so revenue can cover full costs, including costs of financing, operation, loan losses and capital. The capital costs vary with the market rate of interest and inflation. In countries (like Iraq) where the prime rate for commercial loans is less than the rate of inflation, it is advisable to treat the cost of capital as the rate of inflation plus 3-5 percentage points.
<b>3. Essential donor/funder requirements:</b>	<b><i>If not present, donors should fund other activities</i></b>
Sufficient, qualified staff	Agencies should have a person in house, with experience in sustainable microfinance in conflict affected areas, to provide inputs in early program design, select good partners, and conduct Performance-based monitoring.
Patient, long-term perspective	Donors may expect institutions to take longer to become sustainable relative to lower-cost, non-conflict settings. They should commit to 3 years or more. Donors constrained by short funding cycles should coordinate with others to ensure long-term access to funding.
Flexible, longer-term funding mechanisms	Whereas relief operations require large amounts of funding disbursed quickly, microfinance requires smaller amounts disbursed over time at higher administrative cost. Donors should offer grant funding without restrictive or rapid disbursement conditions - even in the face of political pressure.

The over-riding concern and constraint for microfinance, as well as for any other externally supported interventions to develop private sector business services in Iraq at this time, is obviously the security situation, especially in central parts of the country.

International experience suggests that microfinance is not an appropriate development tool to use in what can be termed active war zones. Short-term relief and reconstruction efforts (food or cash for work, infrastructure rehabilitation, health and education services, training, market infrastructure and market information etc.) may be more appropriate to ensure the basic needs of the affected civilian population in preparation for more sustainable development services (see box). This is

**Microfinance Is Not Always the Answer<sup>22</sup>. A Range of Other Donor Interventions Include:**

Investments in infrastructure, e.g., market centers, wells, and electrical or stand-alone generators.

Employment services, including food and cash for work projects and vocational and skills training.

Business development services.

Economic development grants.

<sup>22</sup> Id.

not only because of the dangers involved in operating in a conflict environment but also because of the demand structure – borrowing for a business will be much less of a priority and will represent a (too) high risk for poor households caught in an active conflict. It is, however, crucial that relief and development work are well planned and sequenced from the start so that the groundwork can be laid early and the transition to sustainable development is smooth.

Already in the immediate aftermath of conflict, however, good practice-based microfinance can play an important role in stabilizing and enhancing the economic livelihoods of affected populations. In the early phases of transition, *experience shows that efforts to build and strengthen individual retail microfinance providers yield the best results.*

Strong retail MFIs applying good practices:

Fill the “vacuum” otherwise left open for the large number of unsustainable microfinance initiatives funded and implemented by relief or government agencies, unsupported by technical staff, which often enter the scene immediately following a crisis; and

Minimize the risk of failures and the resultant dashed expectations among customers and local authorities, which affect not only the MFI and the investing donor in the short term, but risks to increase the negative impact on the market in general through e.g. the inculcation of poor repayment culture.

Micro-level activities refer to support to basic micro-entrepreneurial activity. Meso-level activity aims to create a supportive enabling environment (ICT, Credit Bureaus, Banking payment systems, Accounting and Auditing support, etc). Macro-level activity refers to the policy, legal and regulatory environment. Once the situation has further stabilized, support to industry building at the meso-level is important if there is an adequate number of functioning MFIs as depicted in Figure 2:

**Figure 2: Phased Microfinance support interventions in and after conflict<sup>23</sup>**

Phase	Transitional (1-2 years)	Early Stabilization (2-3 years)	Late Stabilization (3-5 years)	Consolidation (5 years +)
Status of MF Conditions	Most essential; Few preferred	All essential; Few preferred	All essential; Some preferred	All essential; Most preferred
Timing and Intensity of Activities	MICRO			
	MESO			
	MACRO			

The key to successful microfinance development, especially in the early phases of transition remains human resource capacity; trained, specialized and experienced staff and management in the MFIs as well as in the donor agencies supporting the MFIs is an absolute and essential requirement for successful microfinance in conflict-affected areas. If it is not available in country, technical expertise must be brought in from elsewhere. The option of attempting to establish microfinance initiatives without strong technical expertise should never be entertained. The international experience consistently documents that sub-standard microfinance does not meet the objectives set out, has only a fleeting impact if any, and leads longer-term negative impacts.

The increasing levels of violence in many areas of Iraq present three types of difficulties that inhibit financial service provision, including microfinance:

The restricted mobility - limiting access to and for clients - to market information, accurate demand assessment, and intermediaries and 'promoters' in the local communities.

The danger to both local staff and expatriate technical advisors and managers, and often to clients receiving loans, as evidenced by reported kidnappings and/or death threats to clients and employees of both MFIs and commercial banks.

An unsustainable level of operational costs due to the security measures that need to be taken to protect staff and/or loan losses due to disruptions in business and lending institution activities.

These threats to successful microfinance are present in most conflict-affected areas. In Iraq, however, the political aspect of the conflict has created an additional obstacle: Microfinance faces a significant '*legitimacy gap*' and is thus not benefiting from the protection that other industries in conflict-affected areas enjoy, by neither customers nor local authorities. There

<sup>23</sup> Tim Nourse, *Microfinance in Challenging Environments; Strategies for Building Inclusive Financial Sectors* (presentation at the CGAP Annual Meeting), Benin, 2006.

are several reasons for this, including microfinance being introduced in 2003 and perceived as a new or simply not understood, and the high levels of suspicion and mistrust generated by the conflict.

So far, central and regional governments have not been engaged in a dialogue to define, delineate, and support an enabling environment for microfinance. Rather than being seen as a non-political, non-partisan private-sector service valued by its customers, microfinance is thus vulnerable to political and sectarian bias and suspicion in the current political climate.

For microfinance to grow to a sustainable scale and provide a valued service to customers in Iraq, it is necessary to manage and mitigate the risks stemming from the current environment of violence and lack of legitimacy. Such measures include:

Building strong MFIs where the business environment allows. Microfinance in Iraq should be focused in the relatively more stable and safe areas of the country, where entrepreneurial activity has recommenced.

To gain and maintain legitimacy, MFIs need to be more – not less – integrated with the local communities they serve and must engage with their markets through appropriate intermediaries, increased information, transparency, responsiveness and impartiality.

Good practices must be adhered to – and thus MFIs and their funders must be provided the technical expertise and experience to appropriately apply them.

Promote a supportive policy dialogue with the government at all levels on microfinance, defining its nature, scope, and contributions to development in Iraq. A clear, streamlined, and coordinated policy framework for microfinance would also help donor agencies realign and harmonize their support to the emerging industry.

## ANNEX 3

# Establishing a Microfinance Network

## Introduction

From its work with over 30 regional and country-level microfinance networks worldwide, the SEEP Network has found that network creation is most successful when driven by genuine member demand and participation. The November 2006 Iraq National Microfinance Summit provided an excellent first opportunity for MFIs in Iraq to share common challenges and identify areas for future collaboration. A session at the Summit on network creation, led by SEEP representative Laura Meissner, found sufficient demand for greater collaboration and information sharing at the national level. Based upon this experience, Iraqi MFIs plan to create an informal microfinance network and complete several collaborative activities.

The network's activities and objectives will be determined by its member organizations. As the industry-wide supporter of microfinance in Iraq, IZDIHAR and USAID are in an excellent position to provide technical, logistical, and financial support to this network. To encourage network sustainability, however, it is crucial that IZDIHAR, USAID, and network members encourage independence of this network as the industry matures.

## Form of the Network

Network best practice indicates that networks should only become formalized institutions when necessary. Given the small size of the Iraqi microfinance industry, an informal forum is the most appropriate form at this time.

Members should be limited to microfinance providers and practitioners active in Iraq. Coordination and dialogue with relevant government authorities and with current and potential donors is desirable and even necessary for Iraqi MFIs. However, the focus should remain on practitioners of microfinance.

The disparity in size and experience of Iraqi MFIs is a potential concern for future network activities. However, at this stage of the industry development, experience sharing between MFIs with different levels of maturity will provide the most benefit for the industry at large.

## Role, Objectives, and Services of the Network

SEEP's *Building Strong Networks: An Institutional Strengthening Guide for Microfinance Networks* (2006) outlines the many roles and functions of regional and country-level microfinance networks. Some common roles of microfinance networks include:

- Gathering and disseminating relevant information.
- Providing or facilitating access to training and other technical assistance.
- Advocating for an enabling policy environment.
- Promoting performance monitoring of MFIs.
- Serving as the point of contact for donors, investors, and other parties.
- Bringing together the various providers and stakeholders in the sector.

The MFI members of the Iraqi network will determine for themselves which member services are most appropriate. However, initial discussions at the Summit indicated that information dissemination, policy advocacy, and capacity building are high-priority activities. It is recommended that IZDIHAR partner with Iraqi MFIs to begin activities in these areas, as discussed below.

## **Network Funding and Donor Coordination and Support**

Resource needs for a new Iraqi microfinance network may include website development, technical expertise in creating a policy statement, and funding to provide training for MFI staff. Although in the future support will be needed to fund business plan activities and staff salaries, the industry is too small at this point to necessitate such a formalized structure. Support for this network, at least in initial stages, would best be provided from USAID via its existing work with IZDIHAR. In the future, if the network grows and becomes a registered entity, diversification of funding (including membership fees, in-kind member contributions, and fees from services) is recommended to ensure operational autonomy.

## **Implementation Strategies**

The recommended next steps to launch network creation are as follows:

- Notice to all MFIs of network creation, including invitation of less-known MFIs.
- Dissemination on a private web site (initially programmed and hosted by IZDIHAR but transitioned to an appropriate Iraqi MFI host as soon as possible) of Iraqi MFI contact information, subject to security concerns.
- Dissemination of microfinance best-practice materials to Iraqi MFIs via the IZDIHAR microfinance portal website.
- Collection of opinions on government microfinance involvement (such as the NBF law and/or the planned MOLSA microcredit program) from Iraqi MFIs, to inform a policy workshop or position paper to relevant government authorities.
- Coordination of several training and TOT workshops for Iraqi MFI staff, bearing in mind the time constraints of MFI staff.
- Continuation of the microfinance Summit, perhaps on an annual or biennial basis.

Note: Currently, the security situation in some parts of Iraq may preclude even the most basic steps towards network creation—such as sharing email addresses or creating a public website. A microfinance network can be an excellent partner in developing the industry and supporting MFIs, particularly in conflict environments when many MFIs lack experience or feel isolated. However, just as there are necessary and preferred preconditions for microfinance in conflict environments, so too are there necessary preconditions for a microfinance network. If the current situation in Iraq does not allow for these steps toward network establishment, security concerns must take precedence.

## ANNEX 4

# Information Communication Technology

Iraq as a whole suffers a lack of ICT HR talent for two distinct reasons: (1) since the first Gulf War, Iraq was isolated from advances in ICT capabilities; and (2) sanctions, combined with a mass exodus from Iraq, have left an HR void in all sectors.

To minimize operating costs and ensure greater speed, accuracy, and flexibility of administration and management tools, MFIs are relying more and more on ICT solutions to manage accounting and transaction-processing needs. In order for the MFIs to remain self-reliant, it is necessary to ensure that their ICT support capability is properly trained. MFIs typically depend on vendor-based solutions, thus out-sourcing this support. However, there are two specific areas where ICT training is needed:

1. Database management, operations, backup, and recovery practices.
2. Network security.

Non-technical MFI staff may benefit from basic PC / MS Office training programs such as those outlined by the ICDL / ECDL (International / European Computer Drivers License).

Lastly, Iraqi MFIs may benefit from a central website dedicated to Iraqi MFIs and informal networking. It would serve as a platform for discussion of MFI interests, and could help the industry evolve in an environment where interaction and communications are otherwise complicated, and dangerous.

## Extending Outreach Using ICT

Recent experiences suggest that the innovative use of existing technologies, such as automated teller machines (ATMs), smart cards, mobile phone technologies, and remote transaction services can significantly expand customer reach, improve quality of service and customer satisfaction, increase data collection and analysis, and reduce transactions costs. It may be noted that the widespread use of information and communication technology (ICT) will increase when it becomes easier, more convenient, cost effective, reliable, and secure for the consumers. Though each delivery technology provides significant benefits, MFIs need to undertake in-depth cost/benefit analysis, study the availability of supportive infrastructure, and study the technology familiarity, language preferences, and literacy of the clients before choosing a technological solution. Generally, MFIs lack sufficient capital to invest in ICT infrastructure, making this an area where bank linkages or donor support in funding, training, and technical assistance may be appropriate. Although it may seem that current conditions may not be conducive to developing the following initiatives at this time, it is worth considering the possibilities that improved ICT could generate. A summary of select ICT solutions for extending outreach, some of which may be practical in Iraq, includes:

**Call Centers.** Call centers can help information dissemination and cross selling of products to all kinds of customers. They can help in assisting customers even in areas geographically distant from the MFI to get information on availability of credit and terms to comply with.

**Toll-Free IVR Systems.** MFIs may provide toll free Interactive Voice Response Systems (IVRS) in a local language to customers as a part of information dissemination strategy.

**Mobile Phone Banking.** Mobile phone banking assists customers in balance inquiries, transfer requests, bill payments, buy/sell trading orders, and other service enquiries. Mobile banking allows users the ability to access financial information, manage financial transactions, and make choices related to purchases via wireless or Internet enabled devices. Integrated systems that combine hand-held computers, smart cards, and sophisticated back-end infrastructure with mobile device would help in putting in place automated credit decisions and transactions system. These systems can extend the outreach by enabling remote transactions, improve customer service by facilitating on-demand credit approvals, and reduce transaction cost by freeing up staff to handle less routine transactions.

**Automated Teller Machines (ATMs).** ATMs can be efficient transaction handlers, freeing up scarce staff and possibly be vehicles for a broader range of financial products. This is one of the successful technologies tried across the globe for transacting banking business. In order to use ATMs in a rural environment, it may be necessary to make certain adaptations to the technology. Where literacy is an issue, supplementing written text with verbal instructions in the local language may help. To work in rural area, in addition to use of a magnetic stripe card and PIN to identify account holders, other approaches like smart cards with fingerprint validation to allow people with low levels of education to avail of the facility may be considered.

**Smart Cards.** Smart cards can reduce communication costs since balances can be reflected immediately on the card and daily transactions can be batched to the central processing site. This is in contrast to the real-time connection required for verification, which is more widely seen in the case of usual magnetic-stripe card process. As applications multiply, smart cards can be used as a common mechanism to identify the cardholder and process transactions. Customers can use smart cards to purchase production inputs, equipment, and inventory. They can also use them to access loans, depending upon the limits sanctioned on the card. Chip-based smart cards could be used to store information pertaining to customer records, credit limit, amount withdrawn against a loan, etc. Moreover, they will be safe alternatives as they carry personal information like picture, signature, or thumbprint, previous credit data etc. In some instances, a few MFIs have found them a useful tool to replace paper transactions and improve the speed and accuracy of services. Since smart cards contain all essential client financial information, transactions can be immediately reflected. There is no need for online access to a network for each transaction as it involves huge cost.

It is necessary to test the technological solutions before putting them into use. Hence, collaborative efforts by banks and MFIs can more cost-effectively design and test technological solutions, and if successful disseminate them for wider use. Further, research to develop MFI technology can be outsourced to IT companies using venture capital support. On successful development, the technology can be patented and licensed commercially through interested IT companies.

## ANNEX 5

# Status of the Microfinance Industry in Iraq

Note: The following paper was originally presented at the Iraq National Microfinance Summit held in Erbil, Iraq, November 13-16, 2006.

## Introduction

Support to the micro, small, and medium enterprise (MSME) sector in Iraq has been identified as a critical element in the effort to improve Iraq's economic potential. Since 2003, a microfinance industry has been forming in Iraq as part of this effort. Microfinance has been supported and promoted by the US State Department through the Iraq Reconstruction Management Office and USAID, as well as by the US/Multinational military through civilian affairs teams. About three-quarters of the Iraqi labor force is engaged in private sector activities, the majority of them informal sector business. The combination of poverty, lack of formal job opportunities, extremely limited bank services and an entrepreneurial culture create intense demand for microfinance services that should remain high for the short to medium term and is likely to continue into the long-term.

There is a financing gap in Iraq. Commercial bank lending to micro and small businesses is virtually non-existent. Demand from the core microenterprise level of informal sector businesses is not being met by current financial services providers. The need for additional investment in microfinance development and expansion is evident.

The Iraq Microfinance Stakeholders Summit for the first time brought practitioners, donors, and other stakeholders together to take stock of the industry, outline the issues facing microfinance in Iraq today, and discuss donor and practitioner objectives achieved through microfinance. The Summit is a forum for all stakeholders to frankly exchange views about the state of Iraqi microfinance and the way forward.

This is an important and appropriate moment for donors to hear directly from Iraqi practitioners and microfinance professionals involved in implementing microfinance in Iraq.

The Summit will be the first step towards developing a comprehensive strategy outline for development of the industry in Iraq.

## Genesis of the Microfinance Industry in Iraq

Prior to the regime change, there were no identified formal sources of microfinance. As is typical throughout the world, an informal market driven system of credit delivery through moneylenders, family, friends, and suppliers seemed to operate quite freely. While such a system is generally quite efficient, it does not reach a wide number of potential entrepreneurs and can be often prohibitively expensive.

In December 2003, the IFC established the Iraq Small Business Financing Facility (ISBFF). This facility is designed to provide funding for micro and small businesses (MSB) on a commercial basis through qualified commercial banks. However, it was found that the banks are barely functional and are having difficulties finding bankable deals for this type of loan. In addition, commercial banks in Iraq had no experience in financing micro entrepreneurs, had not viewed microfinance as a sound profit center for their institutions, and therefore did not provide a formal microfinance alternative.

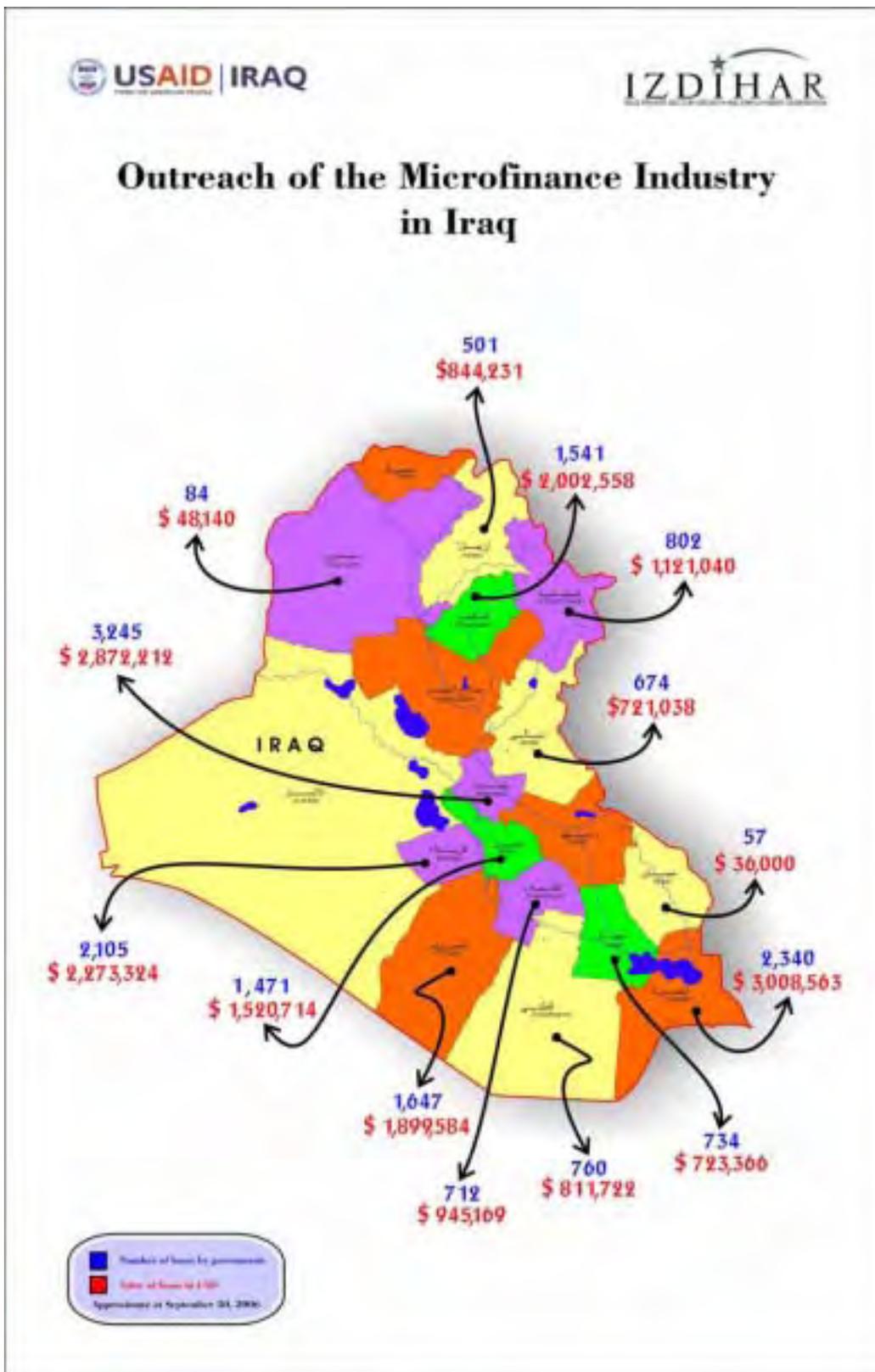
Also in 2003, ACDI/VOCA and CHF were two of five US-based international NGOs that received very large grants from USAID in 2003 under the Community Action Program (CAP). ACDI/VOCA began microcredit operations in January 2004 and established an Iraqi NGO, Al-Thiqa, in February 2004 to carry out the program. Al Thiqa is based in Kirkuk and operates in northern Iraq. ACSI is the credit program started by CHF International. Like ACDI/VOCA, CHF received a major grant from USAID under the CAP program in 2003 for community development programs in southern Iraq. Through these community programs, they realized there was a large unmet demand for finance. In 2003, CHF received US\$21 million to begin a lending program in 2003 with which they established ACSI in the southern part of the country.

In 2005, the Izdihar project provided additional funding and technical support to ACDI/VOCA and CHF and in early 2006 approved funding for another large NGO Relief International. Three small indigenous NGOs, Al Bashair in Rawniya, Al Aman in Kirkuk and Al Inma in Falluja were funded jointly by Izdihar and the Us Military.

Among the larger microfinance institutions, (MFIs) ACDI/VOCA and CHF are operational while Relief International is in a startup phase with five branches and a small but growing loan portfolio. Al Bashair and Al Inma have experienced difficult times due to security issues but Al Aman is progressing quite well with an active cliental and expanding outreach.

## **Current status of the industry**

The following map outlining MFI locations by governance, number of loans and loan volume graphically illustrates the outreach of the formal MFI industry in Iraq today. All of the MFIs are supported by the US Government with funding and technical assistance. The map on the next page shows microfinance outreach in Iraq as of November 2006.



Currently there is a very limited supply of microfinance services; the existing NGO programs serve a combined 15,000 active loan clients. Commercial bank lending to micro and small businesses is virtually non-existent with banks targeted towards high-end small businesses at the lowest level and international firms as the client of choice. Current providers are not meeting demand from the core microenterprise level of informal sector businesses. Most professionals believe there is a financing gap and need for additional investment in microfinance development.

All of the existing MFIs are challenged not only by an ever-changing security situation but also by an immature policy and regulatory system, donor pressure for action and reporting, and the acquisition and retention of qualified personnel. While loan repayment is generally quite good – in most cases excellent – operating efficiencies are eroded through loan portfolios priced below market rates and the cost of security.

Despite the obstacles, donors and NGOs alike continue to move forward with plans for expanded services and locations and are continually adjusting as conditions change. Training programs offered by internationally acclaimed training institutions are not only turning out qualified microfinance professionals, they are also developing a cadre of Iraqi trainers through a Training of Trainers program. Proven software programs specifically designed for smaller MFIs will soon be installed in the three indigenous institutions adding to the framework for continued development of the industry in Iraq.

## **The Way Forward**

There are no precedents for donor and microfinance professionals to draw on for development work Iraq. Experiences in Afghanistan or Bosnia are often cited, but there is no real comparison between them and Iraq. One person starting his second one-year tour with the Corps of Engineers was overheard saying, “this is like trying to implement the Marshall Plan in 1944.” Still, we are charged with the task of designing systems and implementing programs that will result in an effective and viable microfinance industry that will be a significant player in the economic growth of the nation.

So, what is the way forward? Where should we direct the microfinance industry given the unique conditions of Iraq? Our purpose here with the Iraq Microfinance Stakeholders Summit is to put our best effort to the task of mapping the future of the industry in a fashion best suited for – most importantly – the economic enhancement of the Iraqi people and to provide a framework upon which donors and microfinance professionals can build a strong and lasting microfinance industry.