

# Perspectives on Iraq's Private Banks: Growth, Consolidation and Outlook 2011 Annual Report



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**Ahmad Saleh**  
Senior Research Analyst  
ahmad@iraqixchange.ca

**Tom Opdyke**  
Independent Contributor  
tom@iraqixchange.ca



## HIGHLIGHTS.

- ❖ GDP projected to grow **12.6%** in 2012
- ❖ Foreign investment at **record** levels
- ❖ **Capitalization** requirements fortifying banks
- ❖ Bank deposits accounted for **more than half** of money supply for first time in 2009
- ❖ Shortage of **2.5 million** homes presents opportunity for residential financing

## KEY FIGURES.

- ❖ **\$6.1 bln:** Private Bank Assets in 2010
- ❖ **\$456.8 mln:** Private Bank Revenues in 2010
- ❖ **33%** Avg. Deposit Growth from 2006-2010
- ❖ **53%** Avg. Loans Growth from 2006-2011
- ❖ **28.6%:** Record Credit-to-Assets ratio in 2010

## Perspectives on Iraq's Private Banks

### MACROECONOMIC ANALYSIS

The Iraq banking industry is poised to take a huge step forward as outside investors partner with established private banks and possibly create new ones through consolidation.

Investment successes by financial giant HSBC of London, Qatar National Bank and National Bank of Kuwait, combined with a stock market rally led by banks, has foreign investors looking with interest at opportunities in the Iraqi banking sector.

Citigroup, which generates about \$1 billion in revenue from the Middle East, recently opened an Iraq Desk in Amman, Jordan, and chose former U.S. diplomat Dennis Flannery to helm it.

"We are very optimistic about Iraq over the next three to five years," says Citigroup's Flannery, a former Baghdad financial attaché who previously worked at the World Bank and Bank of America. "Our feeling is that good progress is being made, and we expect to see really significant increases in the GDP in coming years, really significant."

Among the encouraging signs:

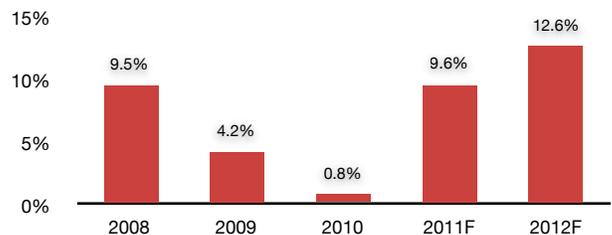
- \$45.6 billion in foreign investment in the first half of 2011, eclipsing last year's 12-month total by about \$3 billion, according to emerging markets specialists Dunia Frontier Consultants.
- Oil sales, at their highest since 1998, are conservatively estimated to increase four-fold by 2025, to about 8 million barrels per day.
- GDP is projected to grow nearly 12 percent by 2015, with per capita GDP rising by 8.4 percent.
- Fiscal policies are helping control inflation, with the government targeting a 5 percent rate for 2012.
- The Iraq Stock Exchange, still young and on many days thin on trading, is up 42 percent so far this year.
- Iraq is less likely to default on debt than Spain, Ireland, Portugal, Argentina and Greece, among others, OTC market analyst CMA of London says.
- Fastest growing construction market in Middle-East, according to property consultants CBRE – with an estimated shortage of 2.5 million homes.

As it emerges from decades of tumult, including the U.S.-led war that began in 2003, Iraq faces challenges that include quelling deeply rooted religious and political

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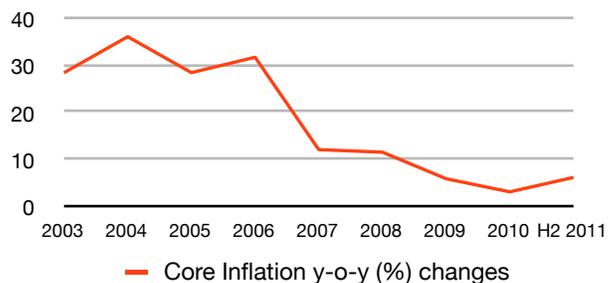
*Dennis Flannery, Citi Country Head - Iraq*

Exhibit 1: Real GDP Growth (%), 2008-2012F



Source: IMF World Economic Outlook (April 2011)

Exhibit 2: Core Inflation (%), YE 2003-2011



Source: CBI (Key Financial Indicators)

conflicts, improving security and creating transparency in a government.

Yet increased oil production, worldwide trade prospects, jobs creation through oil and construction and a semblance of political stability following the establishment of a coalition government are making Iraq a notable investment option, analysts say.

One of the investments is banking, because local and foreign companies are demanding better banking services

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and because the Iraq government has an agreement with the International Monetary Fund to encourage well-capitalized private banking ventures.

"Yes, there is still higher risk in banking but there also is the potential for higher profits," Emmanuel Roussakis, a veteran of the international banking industry and professor at Florida International University. "Being in early can mean you will capture higher market share."

### BANKING INDUSTRY OVERVIEW

#### A rich growth opportunity

The Middle East and North Africa (MENA) banking sector is second only to Asia's in growth potential, according to the 2011 Barclays Corporate Global Banking Survey of 200 top banking and insurance services executives.

A generation of Iraqis grew up without a private banking sector. Banks were nationalized in 1964 and didn't return in private form until 1991, under United Nations pressure. International banking did not return until 2003, when the government removed restrictions on international funds transfers.

To date, Iraq remains a cash-based economy – it is estimated that only one in three transactions involves a bank – and the private banks have focused on earning fees and collecting interest by reinvesting deposits than on lending. A fundamental evolution in banking strategy started in 2009 when the Central Bank of Iraq cut the policy rate and interest rates fell sharply.

"The banking sector is at a very early stage of development in Iraq, one could even describe it as embryonic," Shwan Taha, CEO of Rabee Securities, a brokerage house in Baghdad, told the Abu Dhabi-base newspaper The National. "Any normal banking operation is an opportunity in Iraq."

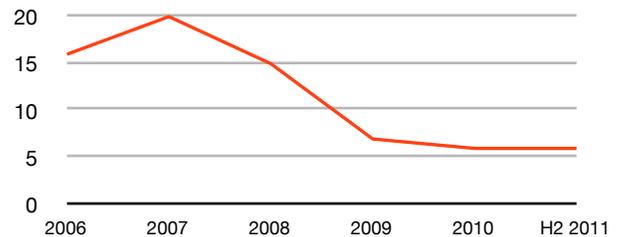
#### Foreign investment begins

Banks from Lebanon, Iran and Turkey now operate their own facilities in Iraq, and many other financial institutions have acquired shares in Iraqi banks.

HSBC, which once operated in Iraq as Imperial Bank of Persia, returned in 2005, acquiring a 70 percent stake in Dar Es Salaam bank. National Bank of Kuwait has a 75 per cent stake in Credit Bank of Iraq.

Iraq has seven state-run banks, which control 86 percent of deposits, and 23 private banks. There also are 12 Islamic private banks.

Exhibit 3: CBI Policy Rate (%), YE 2006-2011



Source: CBI (Key Financial Indicators)

***"The hope is that new capital requirements will bring consolidation, increased investment and more interest from foreign banks."***

*Irfan Chaudhry, Emirates Bank Investment Strategist*

Among the state banks, al-Rafidain, al-Rasheed and Trade Bank of Iraq control the majority of transactions – at least in the short term.

"As we see the banking sector evolve in the coming two to five years, I think that picture will change," says Flannery, the Citi country head for Iraq.

"The government is very seriously looking into the restructuring of the Rafidain, Rasheed banks – those are big banks that enjoy large market share but need restructuring -- and the IMF has put in as one of the conditions in its Standby Agreement that the government restructure banking," Flannery says.

#### Capitalization driving deals

Some of the restructuring is driven by requirements for increased capitalization. Last June, banks were required to reach \$85 million in capitalization. That amount will increase in two stages, to \$213 million by 2013.

"The hope," says Irfan Ahmad Chaudhry, Emirates Bank investment strategist, "is that new capital requirements will bring consolidation, increased investment and more interest from foreign banks."

Among banks reportedly looking for foreign partners or considering mergers are Erbil Bank for Investment and Finance, Bank of Huda, Dijlah and Furat Bank for

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Development and Investment, Gulf Commercial Bank, Trans Iraq Bank and Cihan Bank for Islamic Investment and Finance, Waleed Eedi, head of the CBI's statistics and research department, has told reporters.

The Reuters news agency, quoting an unidentified Iraqi banking official, also reported that state-run Rafidain and Rasheed banks might take a 24 percent stake in Dijlah and Furat.

Union Bank of Iraq, Ashur International Bank for Investment and Mosul Bank for Development and Investment have formally notified the government of their intent to merge, pending government approval. This type of local bank merger is unprecedented in the country.

Standard Chartered Bank of London reportedly has been in talks with the struggling Warka Bank. One of Iraq's biggest private banks with 120 locations, Warka was viewed by many as an innovator; it offers online banking, credit cards and operates ATMs. But it suffered severely when the government withdrew deposits from private banks in 2009, leading to a liquidity crisis. It has not been traded on the ISX for more than a year.

### Technology and management structure

The first round of technology updates in the banking field will be a \$15 to \$20 million project to create a central payment system that would for the first time allow interbank and international payments to occur electronically through a single portal. A secondary benefit: users of mobile phones and the Internet would be able to carry out many banking activities that now require personal visits.

Legislation requiring all banks to tie into the system is still needed.

The technology update is one of many changes analysts hope to see as the banking industry evolves. Two of the most critical are standardized accounting practices and the creation of a legal system more adept at settling contract disputes.

"The banking sector is in dire need of faster reform," says Chaudhry, the UAE banker.

Among them:

- Improved corporate governance
- Creation of regulatory and reporting procedures.
- Trading systems need to be overhauled to reduce the lag between trade and settlement
- Tax structure uniformity

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**"The banking sector is in dire need of faster reform."**

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**"Foreign companies are a lot more interested in Iraq these days. Of course, energy-related companies primarily, but you are starting to see foreign companies in construction and telecommunications, among others."**

*Eddie Kerman, Turquoise Partners Marketing Director*

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"The government has to provide rules of the game and I think it will," says Roussakis, the Florida International University finance professor. "It would be difficult to think it would ignore them when it knows what corporate investors need."

Citigroup, in its Global Economics View newsletter of Feb. 11, 2011, identified Iraq among the Global Growth Generators (G3), as one of 11 countries which have the most promising growth prospects over the next 40 years.

The report sees a 6.1 percent per capita GDP growth from 2010 to 2050 and uses United Nations statistics to project a 103 percent population increase, from 30 million to 64 million, by 2050.

"Foreign companies are a lot more interested in Iraq these days. Of course, energy-related companies primarily, but you are starting to see foreign companies in construction and telecommunications, among others," says Eddie Kerman, marketing director for Turquoise Partners, which manages about \$180 million in Middle East investments.

### PERFORMANCE INDICATORS

As more foreign direct investors move into Iraq, they will find a sector on the upswing, becoming more competitive and diversifying its portfolios. For clarity purposes as we look at indicators, we have classified the private banks by total assets as large (at least 500 billion IQD), medium (200 billion IQD to 500 billion IQD) and small (up to 200 billion IQD).

Data is based on reports from 19 of the exchange-listed banks. Six small, seven medium and six large banks comprise the snapshot. It is believed that the two small banks which have not filed reports as of yet do not cause a significant statistical variation.

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### Bank deposits

Between 2006 and 2010, the exchange-listed banks established a compounded annual growth rate in deposits of 32.6 percent.

While the state banks still control 86 percent of deposits, many of the private institutions are aggressively competing -- opening branches with western-style lobbies, embracing online banking and sometimes offering higher interest on deposits, averaging 6.9 percent on one-year fixed-term deposits in Iraqi dinars.

The growth trend in private bank deposits – from \$1,378 million to \$4,267 million over four years – is especially significant because the government withdrew all state and public institution deposits from private banks in 2009.

Despite the loss, the industry still grew deposits by 25.7 percent in 2009 and 15.8 percent in 2010, mostly by depending on small and medium-sized businesses and attracting private sector customers from the state banks.

By the end of 2009, deposits in state and private banks accounted – for the first time – for more than half of Iraq's money supply, a benchmark for the modern era. In 2010, deposits hit 59.7 percent and are expected to move higher.

Deposits are expected to continue to grow dramatically as the former centralized economy moves more toward a market orientation, thereby fortifying the banking industry to boost its credit-to-assets ratio. Increased confidence in private banks, enticing interest rates, and accelerating business activity are expected to support rapid deposit growth in the medium term.

### Bank Loans

As interest rates fell in 2009 and the Iraqi dinar stabilized, lending accelerated.

Banks that once earned the bulk of their revenue by investing deposits with the CBI and drawing interest had to find other means to bolster the bottom line.

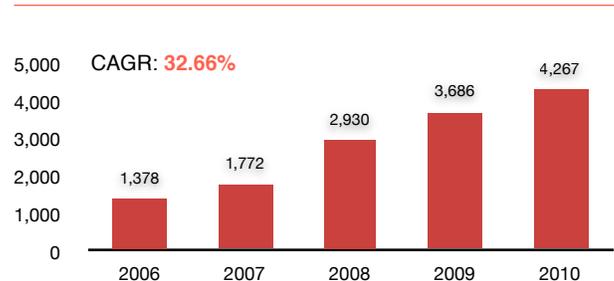
Conventional credit risk was the most attractive vehicle.

Loan portfolios are growing, but it is slow work in a society that does not have a credit culture or a strong legal system for recovery on defaults. Most loans are short term, and mortgages and auto loans are just appearing in the marketplace. The credit culture is still largely driven by collateral lending, secured mainly by real estate.

Nevertheless, credit portfolios grew from \$636 million in 2008 to \$1,721 million in 2010, with *wholesale and retail* business borrowers accounting for more than two-thirds of the loans.

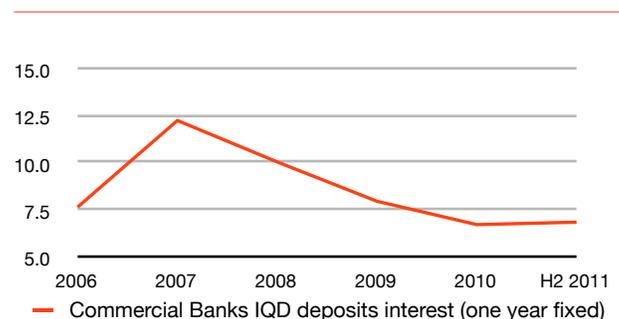
**The growth trend in private bank deposits – from \$1,378 million to \$4,267 million over four years – is especially significant because the government withdrew all state and public institution deposits from private banks in 2009.**

Exhibit 4: Private Bank Deposits (\$mIn), FY 2006-2010



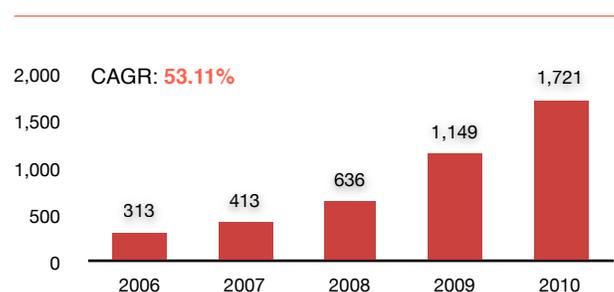
Source: ISC, ISX, Company Reports

Exhibit 5: Commercial Banks Deposit Interest (%)



Source: ISC, ISX, Company Reports

Exhibit 6: Private Bank Loans (\$mIn), FY 2006-2010



Source: ISC, ISX, Company Reports

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A national need to build 2.5 million homes over a decade means the construction industry, which accounted for 11 percent of loans in 2010, is sure to play a more prominent role in borrowing.

“Lending services are being provided in an old fashioned mechanism by the Real Estate Bank, Housing Fund and some private banks,” Faleh Al Ammiri, Undersecretary of the Iraqi Ministry of Housing and Construction told Dubai-based Gulf News. “We look forward to a time when the private banking system takes a (bigger) part in financing investment projects.”

The average credit-to-assets ratio, still low by regional and global standards, hit a record 28.6 percent in 2010.

With all signs pointing to continued credit growth, expected to reach high double-digit percentages year to year, an average credit-to-assets ratio in the mid-30s is likely before the end of 2011.

### Revenue and earnings

As banks begin to embrace their roles as financial intermediaries by lending and providing trade finance services, instead of simply earning a spread on deposits, loan revenues are rising as investment revenues decline markedly.

Core revenues in 2010 tell the transition story:

While fees still accounted for nearly half, loans contributed 37 percent -- up from single-digits in only a few years. Investments, which used to contribute up to 40 percent, were down to 14 percent.

After interest rates plateaued in 2008, the average of bank earnings ebbed slightly in 2009 and 2010 because some banks were slow to adapt to the changing marketplace.

Banks that embraced lending earlier maintained and grew profits despite challenging interest rate environment.

Going forward, with stabilizing interest rate environment and credit and trade finance growing, earnings are expected to pick up. Interim statements show revenue and earnings growing steadily in 2011.

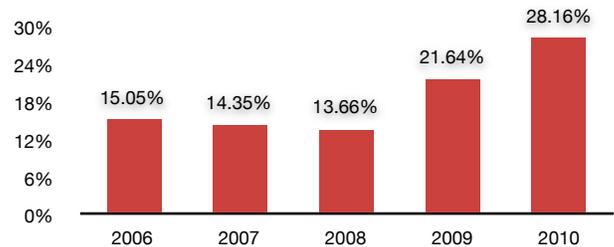
### Capitalization and risk

Banks will have to do some growing of their own to meet new phased-in capitalization standards.

For some, especially the smaller banks, it will be an arduous task that could precipitate mergers or acquisitions.

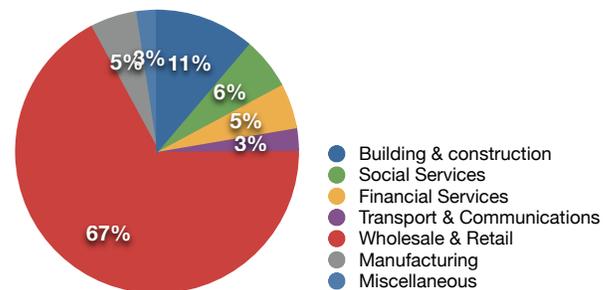
The proposed merger of Union Bank of Iraq, Ashur International Bank for Investment and Mosul Bank for

Exhibit 7: Private Bank Credit-to-Assets, FY 2006-2010



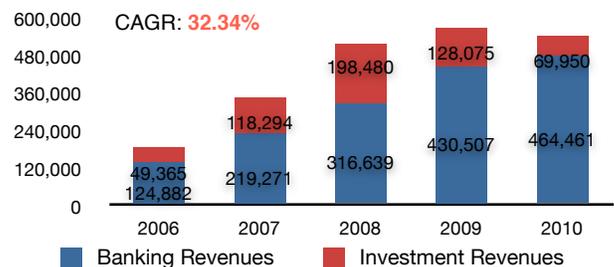
Source: ISC, ISX, Company Reports

Exhibit 8: Bank Lending by Sector, FY 2009



Source: CBI (Key Financial Indicators)

Exhibit 9: Private Bank Revenues (\$mln), FY 2006-2010



Source: ISC, ISX, Company Reports

## Perspectives on Iraq's Private Banks

Development and Investment is not likely to be the last consolidation.

Bank options to meet the capitalization standards include *bonus issues*, through bonus shares distributed to shareholders from surplus profits; *rights issues*, through a paid offering of additional shares issued to existing shareholders; or *external investment*.

Many are likely to use a combination of rights and bonus issues to raise capital. The most profitable banks may rely almost entirely on bonus shares, while some of the marginal ones will turn to shareholders for rights issues.

Despite an uptick in lending activity, private banks remain highly risk averse. Financial leverage of 3.9x in 2010 is considered low by regional and global averages. The risk of relatively elevated levels of provisions for loan losses – estimated at 5-10% – is offset by tremendous liquidity held in cash & short-term investments.

Any expansion in leverage from current low levels is expected to further bolster profits.

### Valuations

When the Iraqi Stock exchange rose 42 percent, large banks were leading the charge, often doubling by attracting fund managers and foreign investors.

But large investors tended to shy away from most small and medium banks, which did not capitalize significantly on the market rally, leading to large disparity in valuation metrics.

While the medium-sized and large banks have roughly parallel growth rates, the P/E and P/B value on medium banks has lagged, creating a noteworthy opportunity.

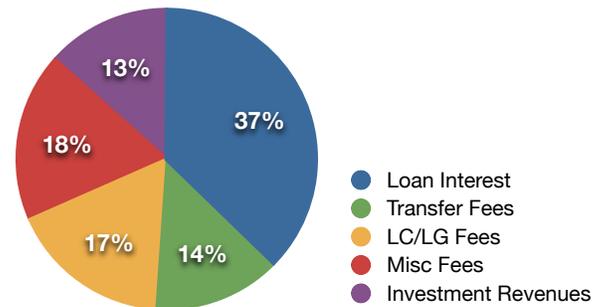
### CONCLUSIONS

The Iraq economy is finding its footing quickly, especially as oil production appears ready to surpass record levels in a short time.

After years of rampant inflation, the Iraqi dinar is stable, and strong markets are developing for small and medium-sized businesses.

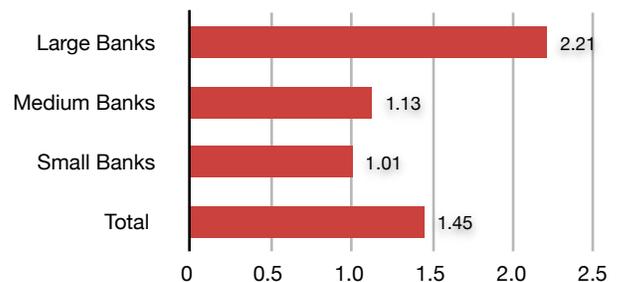
Whether through mergers, acquisitions or individual performance, the Iraqi banking sector is transitioning to a more credit-focused way of producing core revenue.

Exhibit 10: Private Bank Revenue Breakdown, FY 2010



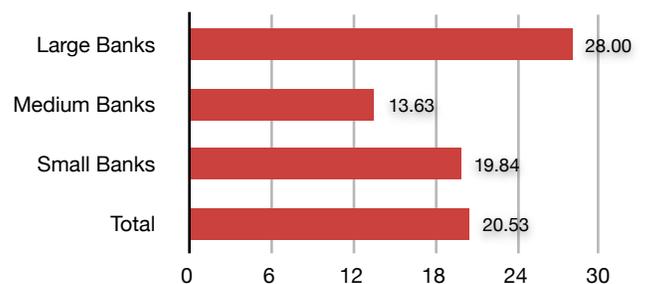
Source: ISC, ISX, Company Reports

Exhibit 11: Average Price/Book by Bank Size, FY 2010



Source: ISC, ISX, Company Reports

Exhibit 12: Average Price/Earnings by Bank Size, FY 2010



Source: ISC, ISX, Company Report

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