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## **Iraq: Microfinance Strategy**

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## **List of Acronyms and Abbreviations**

ACDI/VOCA	Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance
Berger	The Louis Berger Group, Inc.
CBI	Central Bank of Iraq
FSS	Financial Self Sufficiency
FY	Fiscal Year
IZDIHAR	Iraq Private Sector Growth and Income Generation Project
MFI	Microfinance Institution
NGO	Non-Government Organization
OER	Operation Expense Ratio
OSS	Operational Self Sufficiency Ratio
PCMS	Performance Classification & Monitoring System
Tijara	Tijara Provincial Economic Growth Program
USAID	United States Agency for International Development

## **Introduction**

After the 2003 invasion of Iraq by coalition forces, the United States developed a policy to rebuild the Iraqi government and economy. Part of this policy was the establishment of microfinance institutions (MFIs) in the country. Microfinance is the practice of lending small amounts of money to entrepreneurs in developing countries in an attempt to expand the local economy. Prior to 2003, there were no MFIs in Iraq. The United States Agency for International Development (USAID) contracted with The Louis Berger Group, Inc., (Berger) a prominent U.S. based infrastructure engineering company, to manage the U.S.-funded microfinance initiatives in Iraq. Berger has projects across the U.S. and in 140 countries; with expertise in project planning, management, and budget administration. In addition to their work in microfinance, Berger has experience in transportation, infrastructure, communications and the development of schools, hospitals, courts, and police stations. This article analyzes the successes enjoyed and challenges faced by microfinance initiatives managed by Berger, as well as their contribution toward the U.S. strategy for victory in Iraq. This article also offers recommendations for sustaining economic growth in the region.

## **United States' Policy toward Economic Development in Iraq**

In November 2005, President George W. Bush outlined the *National Strategy for Victory in Iraq*. The strategy requires that the U.S. assist the Iraqi people in building a new government focused on political stability, national security, and economic growth.<sup>1</sup>

The economic plan set forth in the *National Strategy* aims to restore Iraq's infrastructure and achieve economic stability, while maintaining international relationships and improving the standard of living.<sup>2</sup> This approach is based on six core assumptions:

1. Iraq has the potential to be not just viable, but prosperous and self-sustaining.

2. A free Iraq is in the economic interest of everybody, including Iraq's neighbors and the greater Middle East. A flourishing Iraq can spur economic activity and reform in one of the world's most vital regions.
3. Increased economic opportunity in Iraq and a growing economy will give larger numbers of Iraqis an economic stake in a peaceful country, and drain the influence of radicals and rejectionists who recruit the unemployed and thrive on resentment.
4. Economic changes in Iraq will be steady but gradual given a generation of neglect, corrosive misrule, and central planning that stifled entrepreneurship and initiative.
5. Iraq can be a reliable and contributing partner in the international economic community, demonstrating the fruits of good governance and transparency.
6. Iraq will need financial support from the region and the international community as its economy transitions from being guided by command principles and hampered by poor infrastructure to having a more self-sustaining posture.<sup>3</sup>

The ultimate goal of U.S. economic development programs in Iraq is to encourage the spread of democracy and to inhibit the influence of terrorist cells in the region.

### **Microfinance Background and Context**

To achieve this goal of economic growth and political stability in the Middle East, the U.S., through USAID, relies on MFIs as a long-term development tool to grow the Iraqi economy. Access to financial services in developing countries, like Iraq, is extremely limited due to a lack of formal banking structures and reduced access to credit for the poor.<sup>4</sup> MFIs address this problem by extending financial services to impoverished communities and individuals by

offering microloans.<sup>5</sup> Microloans generally range from \$50 to \$1,500 each, are short-term, and often carry high interest rates.<sup>6</sup>

Muhammad Yunus, Ph.D. established the concept of microfinance in 1976 when he donated \$27 of his own money to a woman in Bangladesh to start a business.<sup>7</sup> This small act evolved into the Grameen Bank of Bangladesh.<sup>8</sup> The bank was established to extend small loans to women to build businesses and encourage entrepreneurship.<sup>9</sup> Microloans were so successful at combating poverty and promoting stability that Yunus was honored with the Nobel Peace Prize for Economics in 2006. The committee acknowledged that “Dr. Yunus’s simple, but revolutionary, idea was that the poor could be as creditworthy as the rich, if the rules of lending were tailored to their circumstances and were founded on principles of trust rather than financial capacity.”<sup>10</sup> The prize committee recognized that the key to peace is to provide populations with the tools to lift themselves out of poverty.<sup>11</sup> The global microfinance industry has expanded far beyond these roots and has developed a comprehensive set of guidelines to serve the world’s poor.

## **Microfinance Industry Standards**

In developing and war-torn countries, MFIs fill the gap left by the formal banking sector and loan to people who lack collateral and credit. Since MFIs operate in places where the potential for conflict is high, strategies have been developed to help MFIs adjust to instability in order to diminish risk. These strategies include repeated lending, progressive lending and joint liability. Repeated lending distributes loan money in multiple installments. The borrower is put on a frequent repayment schedule to help establish the creditworthiness of the individual.<sup>12</sup> Progressive lending “increases loan disbursements gradually over time.”<sup>13</sup> If a borrower is unable to repay the small loan, he or she will not receive a larger loan in the future.<sup>14</sup> Joint

liability allows borrowers to join together and take turns receiving loans. The members of the group are cosigners to each other's loans.<sup>15</sup> These strategies are effective because the promise of receiving additional loans motivates responsible borrower behavior.

To address the difficulties of lending in post-conflict regions, MFIs provide services that enhance the security of their clients. They work with institutions that hold trust in the local populace and experience in development. Additionally, product design and delivery are adjusted based on both the current economic situation of the country, as well as the level of education of the client base. Collaboration with other stakeholders in the microfinance industry is crucial, along with the hiring and protecting of knowledgeable and effective staff. Microfinance institutions guard their records and utilize technology for remote access to preserve portfolio quality.<sup>16</sup>

## **Microfinance Programs in Iraq**

USAID contracted Berger to address the development and expansion of the microfinance industry in Iraq. In September 2004, Berger won the contract to establish the Iraq Private Sector Growth and Income Generation Project (IZDIHAR), which operated until March 2008. In January 2008, Berger received a second USAID contract to implement the Tijara Provincial Economic Growth Program (Tijara), a follow-up program to IZDIHAR.

A \$150 million contract, IZDIHAR was a multi-faceted three-year program funded by USAID to expand the Iraqi private s and create jobs by developing an entrepreneurial atmosphere.<sup>17</sup> The establishment of MFIs in Iraq was just part of the overall IZDIHAR program. The three primary objectives of IZDIHAR were to:

- Develop a more market-friendly environment for broad-based economic activity and business expansion;

- Help Iraq attain sustained, higher economic growth rates that are private sector-led, employment-generating and equitable; and
- Enhance the viability and growth potential of micro, small and medium enterprises by providing greater, more reliable access to sustainable financial services, training and other appropriate technical assistance.<sup>18</sup>

Prior to the expiration of the IZDIHAR contract in March 2008, Berger received additional USAID funding in the amount of \$160 million to run the Tijara project from January 2008 to March 2011.<sup>19</sup> Tijara, which means “trade” in Arabic, was conceived as a three to five year program to “promote private sector growth and development in Iraq.”<sup>20</sup> Tijara is an extension of IZDIHAR’s prior work with small and medium sized businesses, training, business investment, and reform of trade policy. The five primary objectives of Tijara are:

- Establish, support and strengthen small business development centers and provide support, services and technical assistance to the Provincial Reconstruction Teams;
- Provide training, technical assistance and grants to international and Iraqi institutions to build a sustainable non-bank microfinance industry in Iraq;
- Develop bank lending programs for small and medium sized enterprises to encourage private sector-led economic growth and support sustainable employment opportunities for Iraqis;
- Enhance the capacity of the government of Iraq to develop and implement trade policies in accordance with international standards and treaty obligations; and

- Provide assistance to the government of Iraq to stand up the National Investment Commission and implement the Investment Law.<sup>21</sup>

## **Successes of The Louis Berger Group's Projects**

Both of Berger's programs, IZDIHAR and Tijara, continue to have positive impacts on the Iraqi economy. These endeavors successfully pursue the U.S. objective to combat terrorism through the expansion of private enterprise and local economy, as laid out in the *National Strategy*. One of the early achievements of both programs is the remarkably high repayment rate of microloans in Iraq—reaching 99 percent in 2007.<sup>22</sup> The loan default rate is much lower than other countries despite the larger size of microloans in Iraq.<sup>23</sup> Inability to meet financial obligations results in shame in Middle Eastern cultures. The possibility of this disgrace is strong motivation for MFI clients to make timely payments. MFIs also reduce delinquency rates by using legal prosecution to enforce consequences for failure to make payments.<sup>24</sup>

A major component of the two Berger economic programs in Iraq is the use of knowledge sharing technology and forums to coordinate and improve the development efforts of the region's multitude of non-governmental organizations (NGOs) and government-sponsored actors. IZDIHAR sponsored the Iraq Microfinance Summit (the Summit) in November 2006.<sup>25</sup> The Summit provided an opportunity for institutions and stakeholders to share strategies and discuss common challenges in order to facilitate the expansion and improvement of the microfinance industry.<sup>26</sup> One finding that emerged was the need for MFIs to achieve sustainability by increasing revenues and decreasing costs in order to eliminate reliance on donors to fund operation costs.<sup>27</sup> Summit participants also affirmed the importance, as well as the challenge, of finding competent Iraqi staff members to ensure the continuity of MFIs after

U.S. resources and personnel are withdrawn.<sup>28</sup> IZDIHAR served as a resource and provided extensive training to local Iraqi microfinance employees.<sup>29</sup>

Additionally, IZDIHAR created the Iraq Knowledge Portal, a secure website, which helps Provincial Reconstruction Teams coordinate their strategies for economic development with current USAID projects.<sup>30</sup> This tool improves cooperative efforts by different U.S. funded development groups and MFIs in their development activities. This allows stakeholders throughout the country to collaborate and share information.<sup>31</sup> It also provides structure and reduces redundancies among the many development groups active in Iraq.

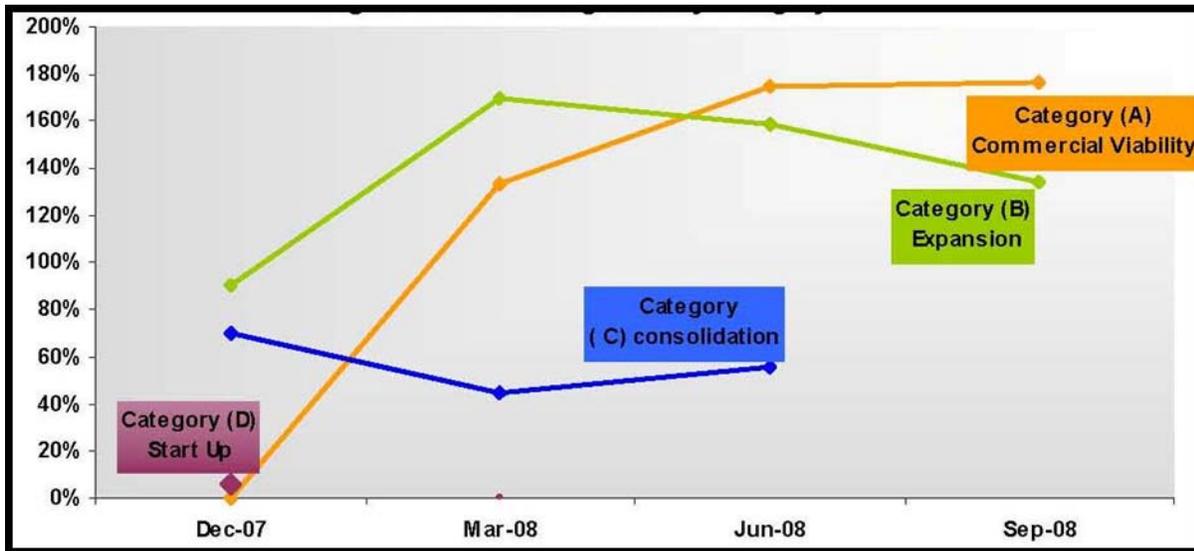
Tijara developed the Performance Classification and Monitoring System (PCMS), a tool that tracks the progress of individual MFIs and the Iraqi microfinance industry as a whole. PCMS enables MFIs to record and report their progress to their donors, lenders and the Central Bank of Iraq (CBI) on a quarterly basis, as well as share their progress with their fellow MFIs.<sup>32</sup> To evaluate MFIs, Tijara instituted the use of global microfinance industry standards; “performance ratios that reflect size and quality within the areas of delinquency management (portfolio at risk), cost control, productivity, and sustainability”.<sup>33</sup> Once MFIs are evaluated, they are ranked at one of the following four stages:

- D: Start-up stage – Up to 500 borrowers having loans of up to \$1 million. Portfolio at risk and operational expense ratios (OER) tend to be high, while loan officer productivity, operational self-sufficiency (OSS) and financial self-sufficiency (FSS) ratios are low.
- C: Consolidation stage – MFIs consolidate and solidify performance by growing their portfolio up to 1,500 clients with up to \$5 million outstanding. Portfolio at risk and operational cost ratios reduced; and loan officer productivity and viability indicators increase.

- B: Expansion stage – MFIs grow to reach up to 5,000 clients with an outstanding portfolio of up to \$15 million. Portfolio at risk, operational expense and loan officer productivity ratios will reach industry standard levels, while viability indicators will be just below the breakeven point.
- A: Commercial viability stage – MFIs will earn a profit and generally comply with international microfinance performance benchmarks. This means a portfolio of over 5,000 clients with more than \$15 million outstanding. Portfolio at risk will be less than 2%, OER will decrease to below 12% and loan officer caseload will generally be above 200. Viability ratios (OSS and FSS) will both exceed 100%.<sup>34</sup>

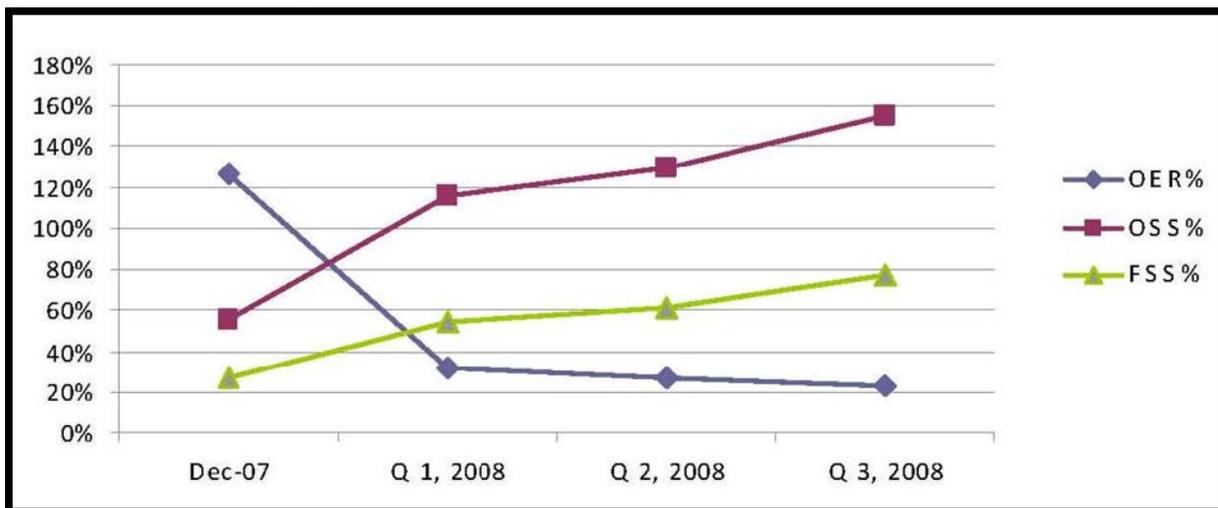
The PCMS results show that MFIs in Iraq have consistently improved their performance. As of December 2008, only one of the ten evaluated MFIs remains in stage C, the consolidation stage. The remaining nine MFIs all fall in stages A and B. This is a notable improvement over the previous years' results. In December 2007, three MFIs were still in stage D, the initial start-up stage, and three others were rated at stage C.<sup>35</sup> The chart on the following page illustrates the progress of MFIs through the ranks of the PCMS scale between December FY2007 and September FY2008.

**Figure 1: Degree of Operational Self-Sufficiency among MFIs by Category<sup>36</sup>**



Microfinance is a long-term development tool. Currently, the microfinance industry in Iraq is too young to conduct a meaningful cost-benefit analysis. However, as more MFIs mature and develop into stage A, the Commercial Viability stage of the PCMS, it is clear that U.S. investment in Iraq is paying off in the form of a sustainable industry. The chart on the following page shows that between December FY2007 and December FY2008, the average cost levels declined while sustainability levels continued to increase.

**Figure 2: Overall Average Performance of MFIs<sup>37</sup>**



## **Challenges Encountered by The Louis Berger Group's Projects**

Berger has succeeded in founding a microfinance industry in Iraq, but there are still several challenges the company must address to ensure long-term success of MFIs in the region. Obstacles to sustainability include difficulties of working in a conflict zone, requirement of guaranteed income for clients, reliance on donors instead of a formal banking sector, and religious customs that hamper expansion of microfinance in Iraq.

As previously mentioned, one of the challenges faced by MFIs in Iraq is the extreme violence and uncertainty citizens have of survival, which inhibits a desire to engage in entrepreneurial activities. Six years after the invasion of Iraq, stability is still elusive. As recently as November 1, 2009, a car bomb went off in Baghdad, the top market for microfinance loans, killing seven and injuring 45 Iraqi citizens.<sup>38</sup> Total civilian casualties since the start of the war are estimated to be between 93,000 to more than 102,000.<sup>39</sup> Not only is violence detrimental to clients, but also to the employees of MFIs.

Religion plays a significant role in the success and failure of MFIs within the region. The Qur'an prohibits followers from paying interest on borrowed money.<sup>40</sup> One MFI successfully addressed this concern by obtaining a Fatwa, an edict of Sharia law, from the supreme Shia leader to allow it to charge Muslim clients an operating fee to cover the costs of the loan.<sup>41</sup> Since Fatwas are not universally applicable and there is no supreme Sunni leader, avoiding this cultural barrier is difficult for MFIs.

Traditionally the population eligible to borrow from MFIs has been limited to the upper middle class or individuals with political connections. The application for a loan requires the client or the cosigner to verify they have full time employment. While this reduces the risk of defaults, it is unrealistic to expect clients to have full time employment in a conflict zone. Many

applications also require that the cosigner be employed by the government, the only entity that reliably pays its employees in Iraq. In practice, this usually limits eligibility to upper middle class Iraqis who are not the target demographic.

Typically, a thriving MFI requires a high demand for funds and low risk in distributing loans. Instability reduces demand for loans because Iraqis are more focused on survival than building new ventures. The lack of reliable security has caused historically safe areas to become dangerous overnight, limiting the ability of MFIs to conduct business. As of January 2007, MFIs in Mosul and Ba'qubah have been forced to terminate their operations because of insurgent activities.<sup>42</sup> Stability is essential to business success and financial return on investments is often unlikely in a war zone.<sup>43</sup>

Another obstacle to the growth of MFIs is the damaged commercial banking system in Iraq. The weak system is slow to process the transfer of funds to MFI branch locations from accounts in the CBI and consistently makes mistakes.<sup>44</sup> MFIs also fear becoming a target of theft when holding cash on site for loan disbursements or traveling to banks to withdraw cash.<sup>45</sup> There are no stable institutional measures to safeguard the transfer of funds from the CBI to its clients, including MFIs. Expanding operations beyond current MFIs in Iraq requires consistent access to credit and a guaranteed reserve system in the CBI.

One of the greatest challenges Berger faces is the lack of transparency in its activities in Iraq. Transparency attracts donors and develops trust, allowing shareholders to make significant investment decisions. Details on Berger's disbursement of grants and funds are difficult to find. Lending information is scarce, and many unlabeled loans are disbursed by Berger's projects to MFIs and other organizations.

## Conclusion

Microfinance is a valuable development strategy that should be continued as Iraq rebuilds its economy. It is a long-term tool that encourages Iraqis to invest in their economy and their country. Berger has administered support and financial assistance to the microfinance industry for five years. The company's experience in the country and institutional knowledge of the culture, people, risks, and other idiosyncrasies will make it a vital leader for Iraqi MFIs in the future.

If Berger adopts the best practices for MFIs in conflict regions, they will have a greater chance of sustainability in Iraq. Microfinance programs in conflict zones require extensive security measures as well as other tactical provisions for safety amidst hostility and conflict. MFIs should take special care to align themselves with the neutral organizations and local leaders to avoid becoming a target for insurgent attacks. In addition to protecting MFIs from violence, Berger should work with local religious leaders to expand the microloan client base. This can be accomplished by obtaining approval or developing zero interest loans with surcharges.<sup>46</sup> To eliminate redundant work by MFIs, Berger should coordinate these efforts to promote MFI services, resulting in greater success.

All MFIs face risk by lending to clients with little to no credit history or collateral. Berger should follow guidelines proposed by the International Monetary Fund and disburse loans through repeated lending, progressive lending, and joint liability plans in order to reduce lending risks. Using these methods, MFIs could reach a wider population of Iraqis and have a greater impact on the development of local economies. This will divert some individuals into employment who might otherwise be susceptible to insurgent group recruiting. James Wolfensohn, the former president of the World Bank, recognizes microfinance's potential to

promote peace. He believes that microfinance “gives dignity to families and hope to families. And it’s the lack of hope that is the greatest cause of bloodshed and intolerance”.<sup>47</sup>

The lack of a formal, regulated banking industry in Iraq forces MFIs to rely on donor organizations to fund their initiatives. There are concerns about the detrimental effect of conflicting strategies among major donors. The World Bank and Berger have similar development goals for the microfinance projects but target different demographics. One strategy markets solely to women who only make up about fifteen percent of the total client population.<sup>48</sup> A second strategy targets young men in an effort to reduce their susceptibility to terrorist recruiting.<sup>49</sup> Donors and MFIs will be more successful if their overall objectives are coordinated so that marketing tactics remain consistent. Berger should also help MFIs end their dependence on donors to ensure survival after U.S. support is withdrawn from the country. Berger’s long-term goals should incorporate an exit strategy, which complements the industry’s progress.<sup>50</sup> If Iraqi MFIs cannot become self-sustainable they will face inevitable peril once U.S. political priorities shift.

To become more transparent, Berger should publicize information on its work with Iraqi MFIs; specifically, providing details to the MIX Market database, an online clearinghouse for microfinance institutions across the globe.<sup>51</sup> MIX Market objectively analyzes MFI performance.<sup>52</sup> Berger should be forthcoming with data and information, thereby making a greater commitment to openness.

USAID should continue to contract Berger, provided that it continues to do the following:

- Use the PCMS to advance industry standards.
- Provide technical assistance and training to MFIs and their employees.

- Hold industry summits and maintain the Iraqi Knowledge Portal to allow collaboration among stakeholders to share their progress, experiences and lessons learned.

However, to ensure the continued development of the Iraqi microfinance industry, Berger must address the following:

- **Improve Local Security:** Additional steps must be taken to provide security to MFI employees. Berger should work with local authorities and institutions trusted by the local population, including police and the U.S. military in some locations, and remain mindful that such leaders can fall out of favor as the country changes.
- **Cultural and Religious Issues:** Due to Islamic restrictions on traditional interest rates, Berger should lead efforts to obtain approval for microfinance products from local and religious leaders. It should also encourage MFIs to adjust product design and development based on client's incomes, customs, and levels of education.
- **Broaden the Reach of Microfinance Loans:** Employ strategies such as repeated lending, progressive lending, and joint liability in efforts to reach poorer clients who lack the support of government employees.
- **Improve Linkages with the Formal Banking Industry:** While the IZDIHAR and Tijara projects allocate resources to the development of the formal banking sector in Iraqi, it is still weak. The banking sector must make significant progress in order to support the MFIs with efficient and accurate management of MFI loan portfolio. Berger should place a renewed emphasis on banking if it is awarded another contract from USAID.
- **Aim for Long-Term Self-Sustainability of the Industry:** Berger should encourage less reliance on donor support by MFIs and incorporate an exit strategy that will allow the industry to thrive once the U.S. withdraws financial support.

· Transparency: Berger must improve transparency of its actions. The company can do this by publishing reports detailing statistics on grant and loan awards to MFIs, along with success stories. Berger must also make more data available to industry monitoring systems, such as the MIX Market Database, in order to increase its accountability within the global microfinance community.

The Iraqi economy is far from stable. As a development tool, microfinance is effective in supporting entrepreneurs, generating local businesses, and encouraging personal investment in Iraq. Microfinance has also proven to increase productive employment, which is essential to economic development: “microfinance helps to activate people’s latent potential and thus makes their welfare more sustainable.”<sup>53</sup> Coupled with political support, microfinance programs encourage citizens to help themselves, rather than rely on government welfare.<sup>54</sup> The Louis Berger Group should continue to use microfinance as a tool to promote economic growth and stability in this sensitive and strategically important region. Berger will be successful in this endeavor if it considers the recommendations made above.

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## Notes

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