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# TIJARA PROVINCIAL ECONOMIC GROWTH PROGRAM

## ACCESS TO FINANCE BY MICRO, MEDIUM AND SMALL ENTERPRISES IN IRAQ



July 31, 2010

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Factors affecting the demand for, and the supply of, finance and financial services in the MSME sector.

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### **DISCLAIMER**

The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

# ACRONYMS

CBI	Central Bank of Iraq
BDS	Business Development Services
BE	Business Environment
BEE	Business Enabling Environment
BMO	Business Membership Organization
COC	Chamber of Commerce
COSIT	Iraq's Central Office for Statistics and Information Technology
FG	Focus Group
GDP	Gross Domestic Product
GOI	Government of Iraq
HR	Human Resources
ID	Iraqi Dinar
IHSES	Iraq Household Socio-Economic Survey
IMF	International Monetary Fund
MENA	Middle East and North Africa region
MFI	Micro-Finance Institution
MoPDC	Ministry of Planning and Development Cooperation
MSME	Micro-, Small, and Medium Enterprises
PRT	Provincial Reconstruction Team
SBDC	Small Business Development Center
SME	Small and Medium Enterprise
SOE	State Owned Enterprise
SPSS	Statistical Package for the Social Sciences
USAID	United States Agency for International Development
USD	United States dollar

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# EXECUTIVE SUMMARY

## 1.1 PRINCIPAL FINDINGS

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- In Iraq, credit to the private sector as a proportion of GDP is one of the lowest on record. [see section 1.2]
- MSME owners report the lack of access to finance as their most pressing restriction, ahead of security and energy shortages. [see section 1.2]
- Level of indebtedness of Iraqi MSMEs is extremely low, with 81.6% reporting no indebtedness. Average debt of the remaining 18.4% of MSMEs was 19.3 million ID. This includes indebtedness from all sources other than supplier and customer advances. [see section 1.3]
- Overall, average debt is 3.5 million ID, 3.5% of the average MSME asset value. [see section 1.3]
- 89% of MSMEs have never accessed a loan, whether from a bank, a money lender or a microfinance institution. Bank financing was a source of funds for 5% of MSMEs, microfinance was a source of funds for 3.6% of MSMEs. Among industries, construction was by far most successful in accessing external financing of all types and in utilizing bank services. [see sections 1.4 and 1.13]
- Of the three abovementioned sources of external finance, money lenders were most common. Compared with banks, twice as many MSMEs accessed finance from money lenders. Recourse to money lenders was not confined to the smaller MSMEs or to borrowers with lower educational levels. [see sections 1.4 and 1.5]
- The size of the MSME, whether measured in terms of assets or the number of employees or turnover, is one of the most reliable predictors of access to finance. Evidence shows that MSMEs attempt to accommodate this fact by establishing their operations as a partnership of two or more businessmen. [see section 1.10]
- Several other factors also correlated strongly with access to finance, even after controlling the data for enterprise size; in other words, MSMEs with certain characteristics had a higher chance of accessing finance regardless of their size. These characteristics [see section 1.10] were:
  - extent and sophistication of its bookkeeping and financial reporting
  - use of technology, particularly in marketing
  - use of bank services such as money transfers, checking accounts and business accounts
  - type of primary customer
  - degree of formality evidenced by registration with government authorities and membership in business and professional associations
- It would appear that the low level of debt is not due to a lack of demand for funds but to the lack of supply of funds. MSME owners' expressed need for funds is more than ten times higher than their current indebtedness, with the total volume of desired borrowing amounting to 40% of the stated total value of MSME assets. The appetite for borrowing is disproportionately higher among the smaller MSMEs. [see section 1.16]

- Strong resistance to high interest rates was declared by the respondents. 84% of those with no loans cited high interest rates as one of the reasons. When asked about the interest rates they would be willing to pay for a loan, 83.4% quoted interest rates up to 4% and almost no one quoted interest rates above 10%. [see sections 1.11 and 1.12]
  - The abovementioned resistance to high interest rates may be largely declamatory. More than half of businessmen (58%) who had stated the interest rate they paid on their loans cited rates above 10%. Of these, a half (47%) declared willingness to pay only up to 4% for a loan and no one claimed to be willing to pay more than 10% for a loan. In other words, declared intent is at odds with actual behavior – readiness to pay is far greater than the willingness to pay declared in the survey.
- In 2009, outstanding loans to the private sector amounted to \$3.9 billion, with an estimated \$78 million being SME loans extended by private banks<sup>1</sup>.
- The size of MSME lending market has been estimated at \$850 million. [see section 1.17]
- There are regional differences in the level of MSME bank financing which cannot be explained merely by differences in the composition of the sample. Some provinces were consistently at the top of the rankings for a number of indicators (Wasit, Qadisiya and Babil) while others were consistently at the bottom (Basra, Dhi Qar, Anbar, Karbala). [see sections 1.7 and 1.8]
  - For example, in Wasit, banks were a frequent or occasional source of financing for 16% of MSMEs, nearly ten times the rate for Karbala (1.7%).
- The proportion of MSME entrepreneurs reporting access to microfinance was highest in Babil, Diyala and Wasit, lowest in Basra, Dhi Qar and Karbala. Construction firms reported access most frequently, energy sector MSMEs least frequently. [see section 1.6]
- The proportion of MSME entrepreneurs using finance from money lenders was highest in Erbil, Najaf and Mosul, lowest in Karbala, Basra and Muthanna. Construction firms reported access most frequently, communication sector MSMEs least frequently. [see section 1.5]
- Tables in section 1.15 provide an analysis of additional services that MSMEs would like to be provided by banks, showing potential business opportunities for value adding non-lending activities. [see section 1.15]
- The overall size of SME bank lending by private banks is likely to expand in the future as banks become more comfortable with this segment of the market and as MSMEs learn to become more adept at conforming to banks' expectations in applying for bank credit. USAID in Iraq is working to bring this outcome about by working with private sector banks to increase their SME loan portfolio and by working with SME entrepreneurs, through the Business Development Services Component, to increase their skills in accessing bank finance.

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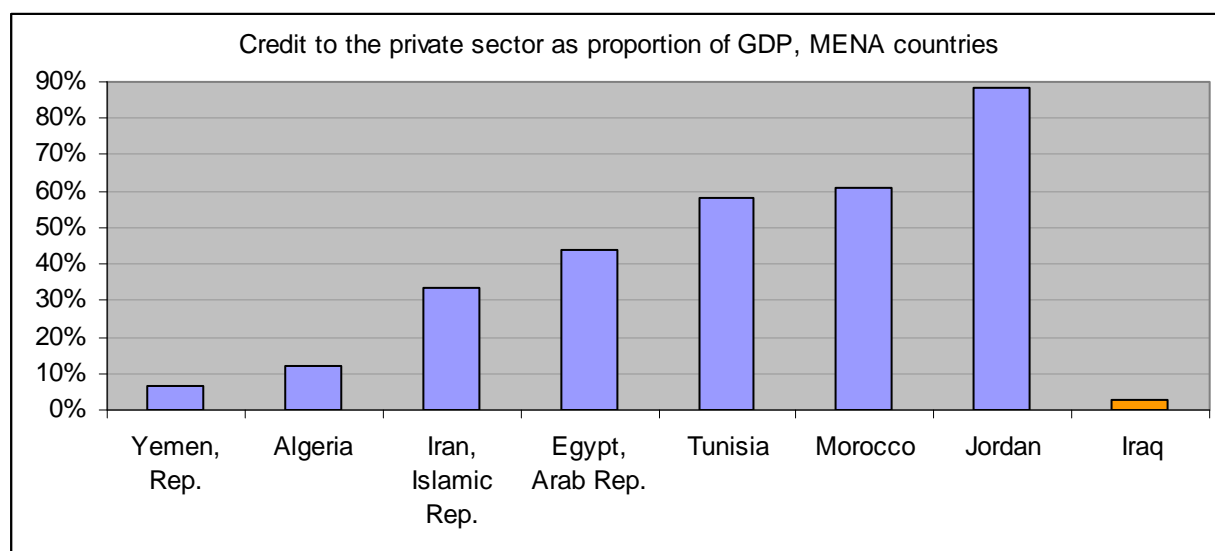
<sup>1</sup> A review of USAID-*Tijara*'s partner banks has shown that SME loans accounted for 4.83% of their lending portfolio in 2009. Applying this proportion to the total credit provided to the private sector by private banks (1.9 trillion ID) would yield 91 billion ID (\$78.6 million) in SME loans. This amount is at the upper bound of probability since private banks participating in the SME Lending Units program can be presumed to have a higher proportion of their portfolios devoted to SME lending. The proportion of SME lending done by state banks is not known (state banks' lending to the private sector is 2.74 trillion ID).

## 1.2 BACKGROUND TO THE STUDY

Lack of access to finance is generally held to be an extremely serious constraint to economic development. In February 2010 IMF released a document called 'Constraints on Growth in the MENA Region'.<sup>1</sup> This study attempts to quantify the impact of the various constraints faced by local businesses that are surveyed in the World Bank's Business Enterprise surveys. Its empirical results suggested that "the key direct constraints to growth in the MENA region are difficulties in access to finance, labor skill mismatches and shortages, and electricity constraints".<sup>2</sup>

Access to finance constraint is particularly applicable to Iraq, one of the least banked countries in the world. Based on IMF's March 2010 'Staff Report for the 2009 Article IV Consultation', credit to the economy as percentage of GDP over the past three years has been increasing from 4% in 2007 to 8.2% in 2009, with the projection for 2010 being 9%,<sup>3</sup> a level that is very low by international standards.

Looking at the credit supplied to the private sector, in 2009 deposit taking banks in Iraq provided 4.65 trillion ID (\$3.9 billion), 3.3% of GDP.<sup>4</sup> A multiple of that amount would be required to bring Iraq's performance in line with the average for lower middle income countries which is 33.54%.<sup>5</sup>



Iraqi banks use only a fraction of their assets for lending.<sup>6</sup> Loans amount to only 14.7% of the deposits in the banking system.<sup>7</sup> This is in stark contrast to other lower middle income countries where credit amounts to 87.9% of deposits (112.6% for high income countries).

What do these statistics mean in practice for micro, small and medium enterprises?

Until recently, there has been a paucity of data regarding the financing of Iraqi MSMEs. The first large scale survey of Iraqi MSMEs was conducted in the latter part of 2009 and early 2010 by the USAID-*Tijara* project. Over 11,000 MSME<sup>8</sup> owners and principals in 15 provinces of Iraq<sup>9</sup> were interviewed on a wide range of issues, including access to and demand for finance and financial services. Data from this segment of the survey is analyzed in detail in the present study in order to obtain a more specific understanding of the situation prevailing in different regions and MSME sectors. The number of cases allows an examination of relationships at the second level of disaggregation.

'Access to Finance' looks at the correlation of financing issues with various aspects of MSMEs: the industry sector, the length of time they have been operating, their size, changes in turnover, level of indebtedness. Analysis comparing the provinces is also being used. However, using different provinces as the primary unit of analysis was not found to be a useful approach because, in the survey, the number of enterprises that was to be polled in each industry was pre-determined by the researchers thus possibly affecting the results with selection bias.<sup>10</sup>

The following means of funding the MSMEs were investigated: financing from personal savings, from business savings (retained profits), from banks, microfinance institutions, money lenders, family and friends, grants, partnerships and supplier and customer advances.

The intent was to look at results which could be of use of bankers as well as MSME policy makers – the patterns of usage of financial services and their importance to MSME owners. Which are the most underserved groups of MSMEs, regionally and sectorally? What are their characteristics?

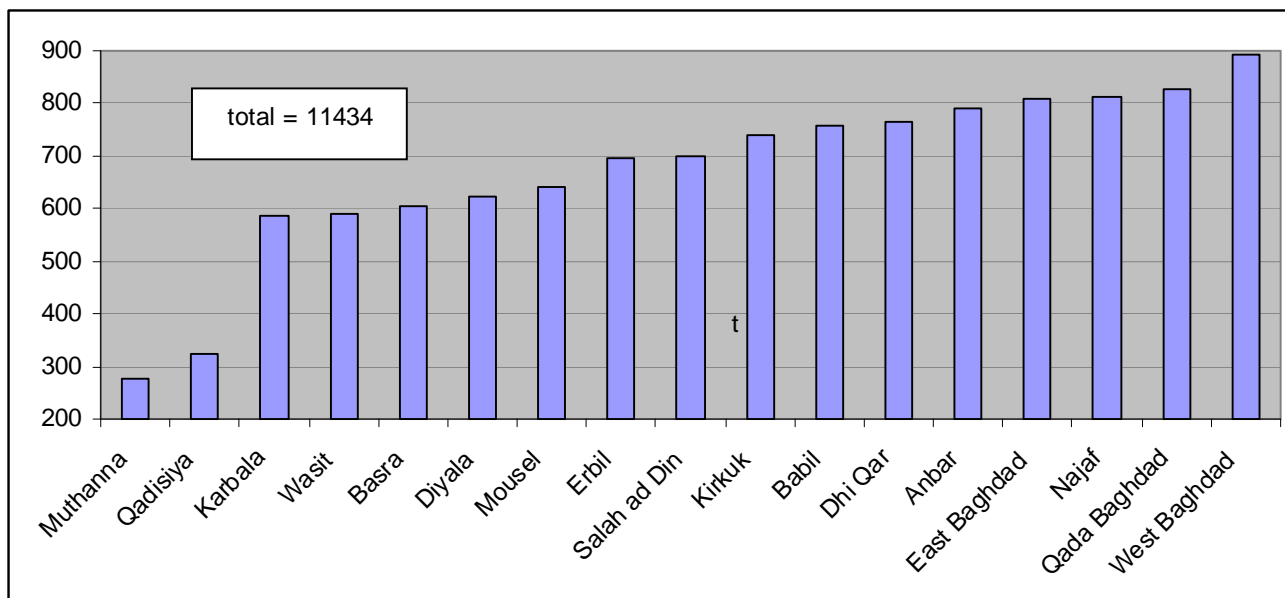
Answers showing the extent of financing needs of MSMEs, additional services which the MSME owners would like to see provided by the banks and the provinces where the branch coverage is inadequate to these questions should be of some interest to Iraqi banks in their attempts to increase the scope, extent and geographic coverage of their services.

Accessing finance from microfinance providers and money lenders is also an issue that is investigated in this study.

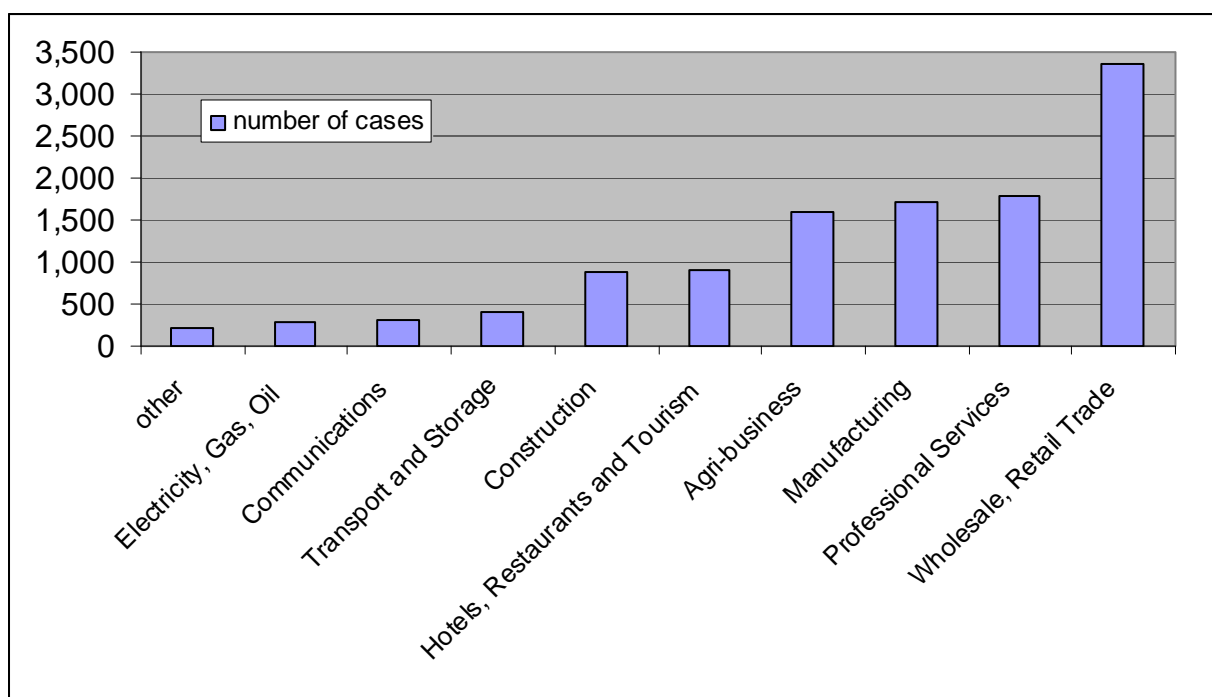
### **Methodology of the Market Assessment surveys**

Multistage stratified cluster sampling was used to draw the survey sample. The manufacturing, agribusiness, and hospitality and tourism sectors were over-enumerated to ensure adequate representation. The sample was stratified by enterprise size using the following categories provided earlier: 1-2 employees, 3-9 employees and 10-29 employees. Enterprises were surveyed both in the capital cities as well as in regional centers. In each province, 10 teams of two surveyors were employed, together with an area coordinator and two quality control supervisors responsible for providing supervision and guidance to the research teams and randomly visiting and calling enterprise owners to validate survey responses. An introductory note to enterprise owners was attached to individual surveys, explaining the goals of the surveys, how people were selected to participate, a charter of their rights as survey participants, and contact information should they have any complaints or suggestions. To ensure the completeness, consistency, and credibility of collected survey data, several control procedures were put in place at the data collection and processing stages. At least 20% of all completed surveys underwent phone validation with the enterprise owners (this was done by another team operating in Baghdad). After randomly selecting batches of selected surveys, USAID-*Tijara* field staff also visited respondents to validate survey data. Once completed survey data was populated into SPSS, duplication tests were run to identify patterns of duplication from the same research teams and researchers' results were benchmarked against one another and against total population sets to highlight standard deviation differences. The data entry quality control process re-entering randomly selected survey data and running discrepancy tests to check for any keystroke or entry errors, and arithmetic checks that balanced totals for salient survey variables such as 'number of employees,' 'asset holdings,' etc.

This study uses a data set merging data from all 17 areas surveyed. The table below gives the number of responses in each area used in the study:



The table below gives the number of responses in each industry that was used in the study.<sup>11</sup>



Tables showing the sample composition in each province are in the Technical Appendix.

<sup>1</sup> IMF Working Paper WP/10/30, Rina Bhattacharya and Hirut Wolde.

<sup>2</sup> IMF staff estimated that reducing the access to finance constraint from the average of the MENA region (33% of firms affected) to the world average (31% of firms affected) could increase real per capita GDP growth by over 0.1 percent per annum in the region. Reducing the labor skill shortage constraint from the average of the MENA region (33% of firms affected) to the world average (21% of firms affected) could increase real per capita GDP growth by over 0.4 percent per annum. With regard to labor skill issues, Iraq's MSME owners report this constraint far less frequently than businessmen in

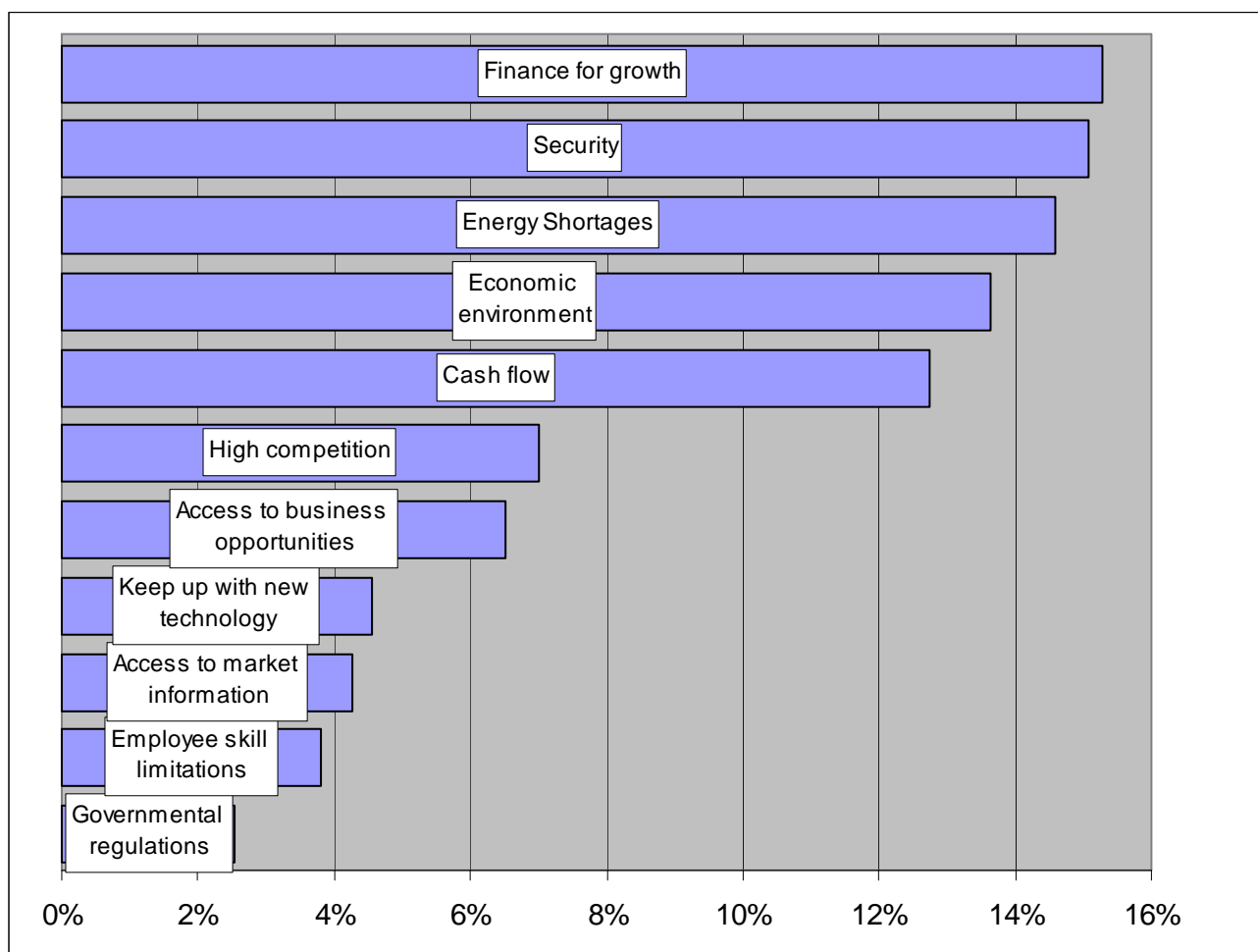
other MENA countries. In the USAID-*Tijara* survey it was an issue for only 3.8% of respondents, ranking last among the 11 constraints dealt with below.

- <sup>3</sup> IMF's estimate for credit-to-non-oil-GDP in 2010 is 21.6% while the projected ratio of non-oil to overall GDP is 41.6%.
- <sup>4</sup> The percentage is derived from 2008 Annual Statistical Bulletin of the Central Bank of Iraq (CBI). It should be noted that there is a striking difference between nominal GDP figures between GOI and IMF estimates (GOI - 156 trillion, IMF – 111 trillion). However, even when basing the calculation on the lower IMF numbers, an additional 33.6 trillion ID in credit would have been required to match the lower middle income countries' proportion of credit to the private sector. This would have equaled the total 2008 deposits within the commercial banking system (34.5.trillion ID).
- <sup>5</sup> The data available for two of Iraq's neighbors also show much higher percentages of credit to the private sector by deposit taking banks. In the case of Iran it was 33.4%, in the case of Jordan it was 88.6%. International comparisons come from the International Financial Statistics for 2007, IMF.
- <sup>6</sup> 1.4%, although, for private banks, the ratio of credit to assets is a much higher 13.3%.
- <sup>7</sup> Loans to the private sector amount to 12% of the deposits in the banking system while loans to government entities are an additional 2.7%.
- <sup>8</sup> Enterprises with fewer than 30 employees, following the classification used by COSIT.
- <sup>9</sup> Babil, Salah ad Din, Najaf, Anbar, Dhi Qar, Erbil, Kirkuk, Muthanna, Qadissiya, Karbala, Mosul, Basrah, Wassit, Diyala and Baghdad. Baghdad's sample was the largest – 2543 enterprises - since three separate areas were sampled – East Baghdad, West Baghdad and Baghdad's Qadas.
- <sup>10</sup> To ensure that situation in all industry sectors is adequately examined, industry quotas were set prior to the survey being conducted. Since different industry sectors have different characteristics, a larger weighting given to a particular industry in a particular province affects the overall results for that province.
- <sup>11</sup> Category 'other' has been excluded from the analysis of industries.

## MSME owners' ranking of business constraints

How important are financial issues to Iraqi MSME owners?

When asked to nominate the top 5 concerns that hinder the growth of their businesses, raising finance for growth was placed highest among the 11 options presented.<sup>2</sup> Respondents were asked to rank the issues from 1 to 5. Results shown in the Graph below are the overall results, after weighing all replies received by the importance assigned to each rank.<sup>3</sup> The results sum up to 100%.



The overall results obscure the variations among different industry sectors. For example, for manufacturers energy shortages are more important than finance while for the construction industry it is security. Below is a table showing the ranking within different industry sectors.

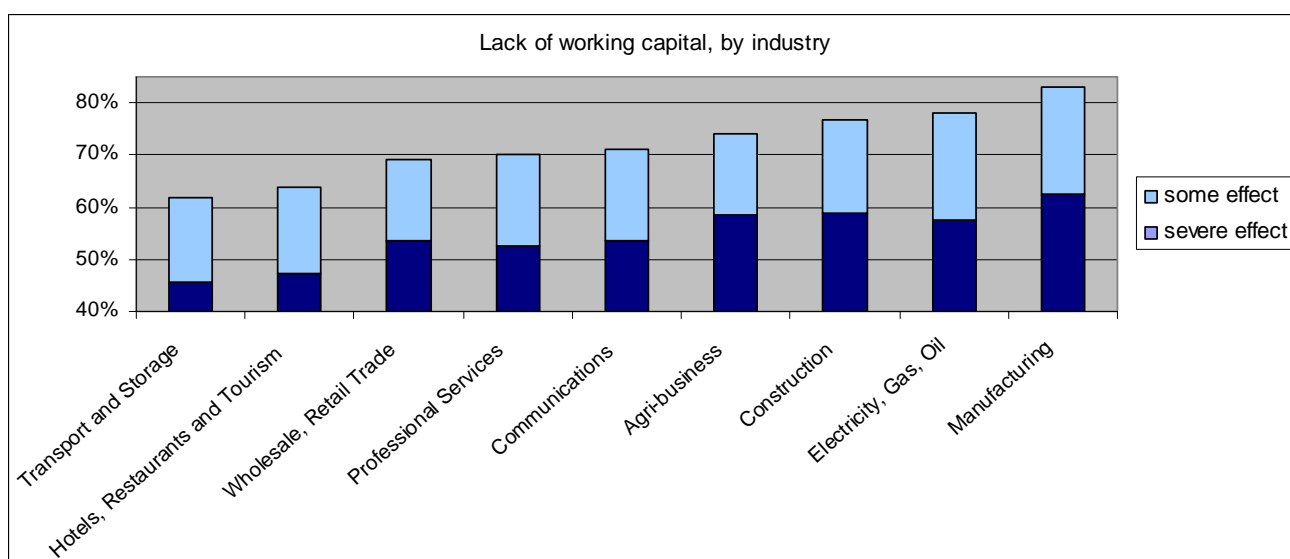
<sup>2</sup> These options were presented in the following order: Cash flow; raising finance for growth; access to market information; access to business opportunities; security; employee skill limitations; economic environment; keeping up with new technology; energy shortages; high level of competition; governmental regulations.

<sup>3</sup> Weighted ratings were generated by giving ordered weights to the different responses depending on their top five rankings in response to the question, multiplying the responses by these weights and dividing by the total number of responses. A weight of 5 was given to the top ranked response, a weight of 4 to the second highest ranked response, and so on until a weight of 1 was given to the 5<sup>th</sup> and lowest ranked response.

Weighted ranking of constraints	Agri business	Construction	Manufacturing	Services	Wholesale, retail	Transport, storage	Hospitality	Communications	Energy
Finance for growth	1	2	2	3	2	2	4	4	2
Energy shortages	2	5	1	2	5	4	1	1	1
Security	3	1	3	1	1	1	2	2	3
Economic environment	4	3	4	4	4	3	3	3	4
Cash flow	5	4	5	5	3	5	5	5	5

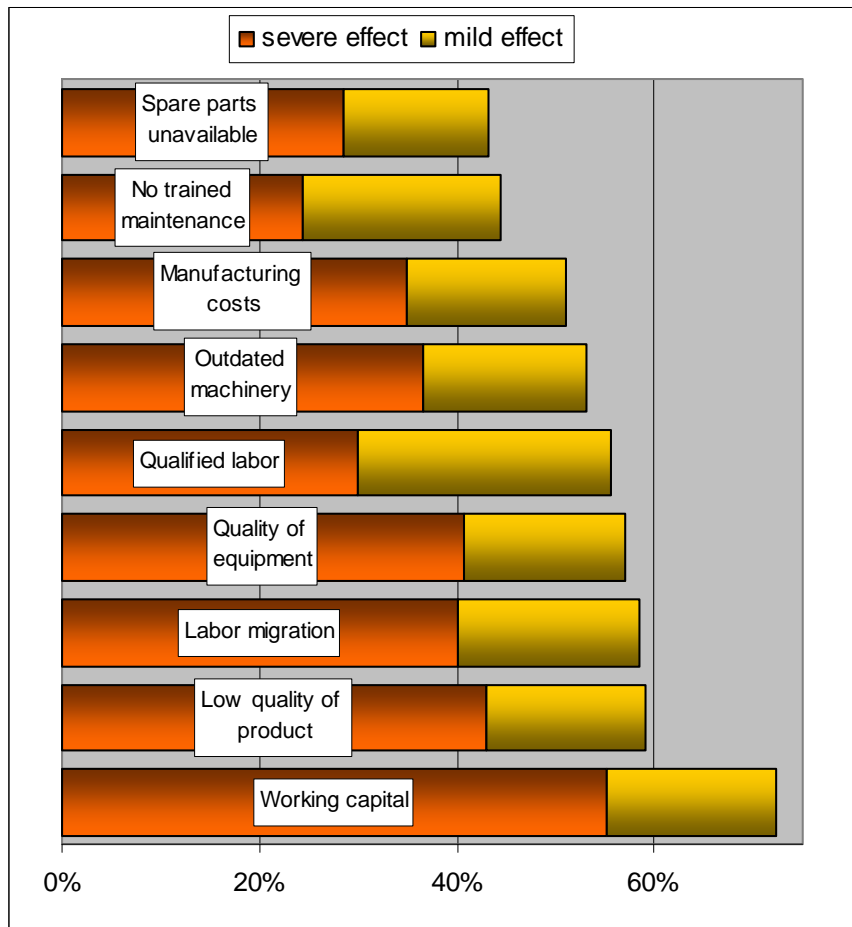
In another part of the questionnaire, respondents were asked to classify various operational constraints as 'not applicable', 'no effect', 'mild effect' and 'serious effect'. The combined answers for mild and serious effect for various issues ranged from low forties to high fifties, with the exception of 'lack of working capital' which scored 72.2%.<sup>4</sup>

Across industries, this percentage varied from 62% for transport to 83% for manufacturing.



<sup>4</sup> The issues were listed in the following order (the number in brackets shows the result): quality of equipment (57%), level of manufacturing costs (51%), low quality of products (59.1%), lack of working capital (72.2%), lack of qualified labor (55.6%), high labor mobility (58.6%), outdated technology (53.2%), lack of spare parts (43.1%) and lack of trained maintenance staff (44.4%).

The table below shows the reported frequency for all operating constraints:

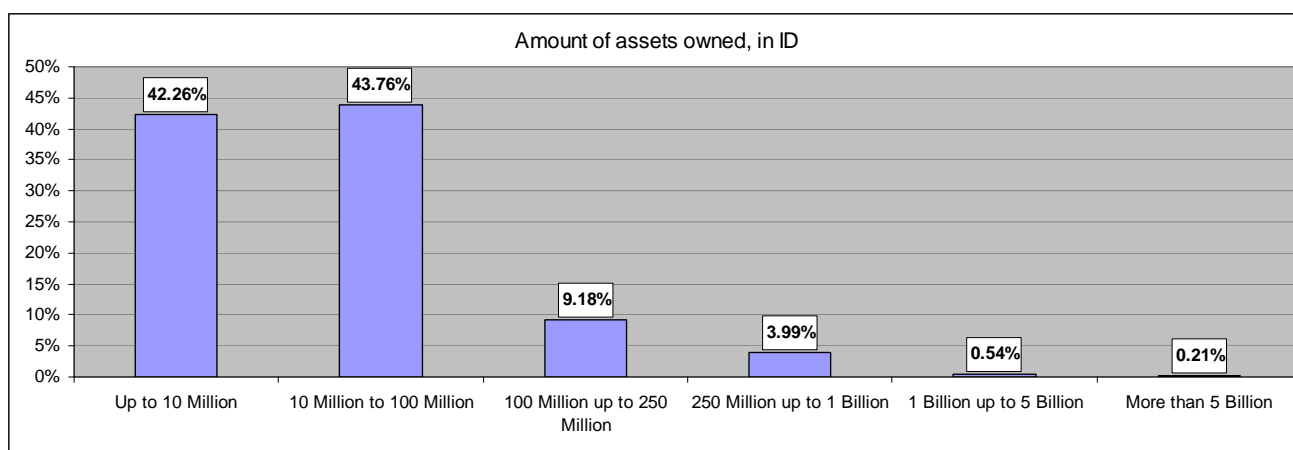


# FINDINGS

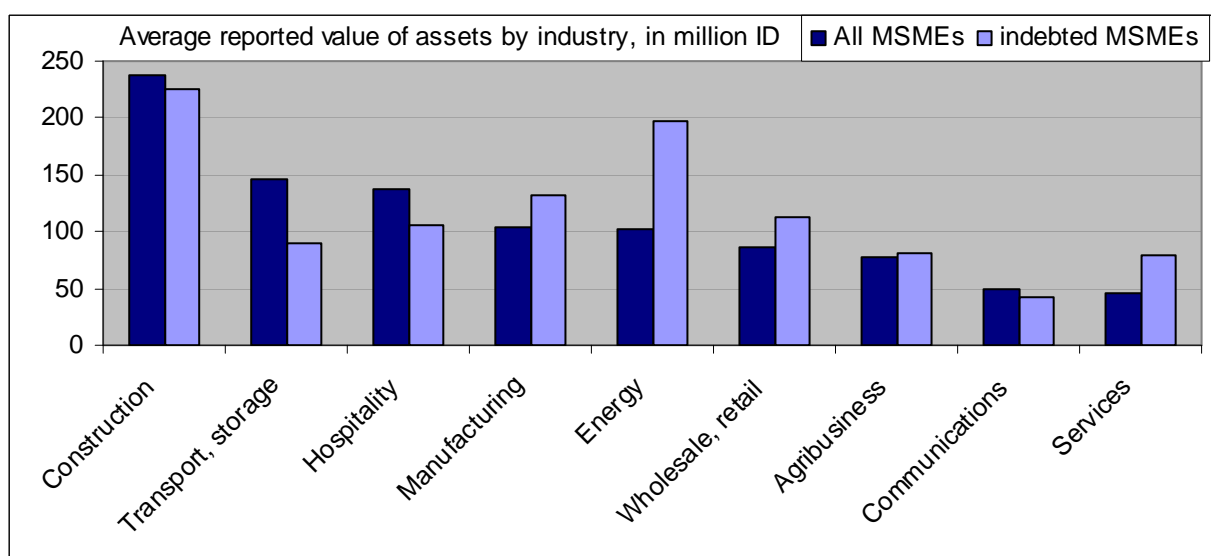
## 1.3 FINANCIAL STRUCTURE OF MSMES

### Asset Ownership

The bulk of Iraqi MSMEs in our sample have assets below 100 million dinars. Taking mid-interval value in the table below, average value of assets has been calculated to be 98.9 million ID.<sup>5</sup> The total asset value of the MSMEs surveyed<sup>6</sup> comes up to over one trillion dinars.



Asset ownership varied by sector, with average assets in the construction industry being more than five times higher than in the sector of professional services.



<sup>5</sup> To overcome the anticipated reluctance and/or inability of MSME owners to provide precise information about their asset ownership, respondents were asked to mark one of several options containing a range of values. Overall values and averages calculated on the basis of taking mid-points of ranges contain an in-built imprecision. The largest asset size groups (above 1 billion ID) was dominated by firms in construction and trade sectors.

<sup>6</sup> Excluding 7% of MSMEs which replied 'don't know'.

The graph above also shows average asset values for MSMEs that are indebted. As can be seen, credit has not been the means to growth in all industries (in fact, in transport and storage sector the average asset value of indebted companies is 40% lower than the overall industry average and in the hospitality industry it is 23% lower).

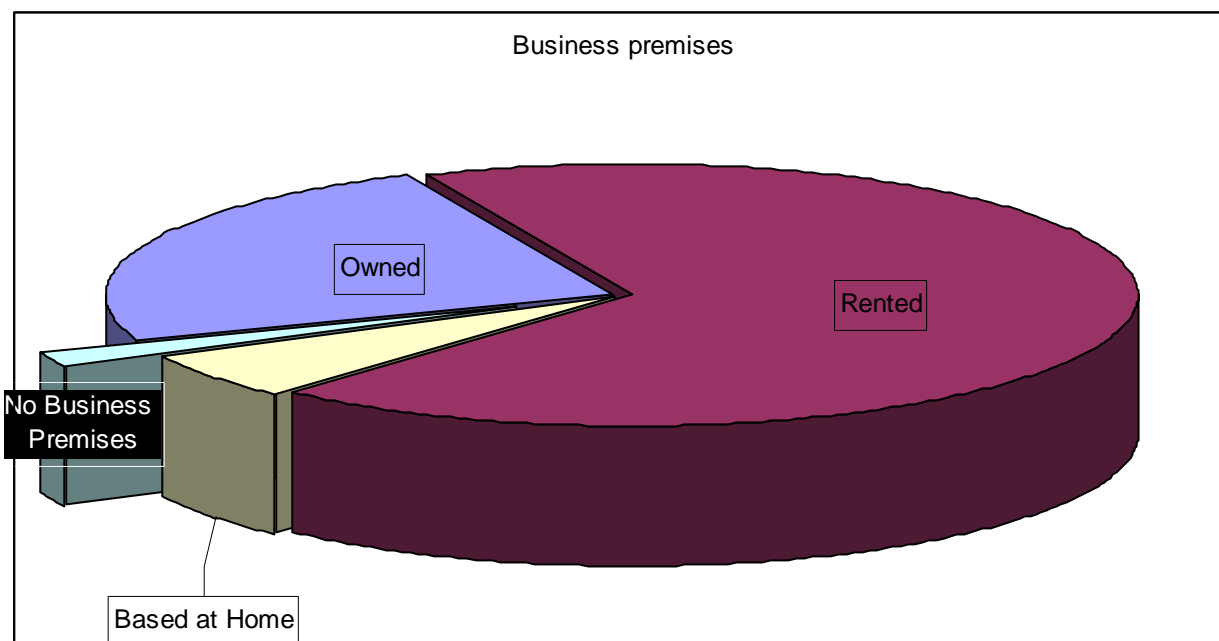
Regionally, average asset values varied from 394 million ID in Erbil<sup>7</sup> down to 34.8 million ID in Diyala.

Asset values are related to the employment size of the enterprise. MSMEs with up to 10 employees show an average asset value of 49 million ID, MSMEs between 11 and 20 employees show 102 million ID and those between 21 and 29 employees show 276 million ID.

### Asset Composition

Additional Market Assessment survey questions looked at the asset composition of Iraqi MSMEs. In view of the fact that Iraqi banks are conservative and prefer asset-secured lending, the findings go some way towards explaining the low level of bank financing.

Most MSMEs operate from rented premises. Only 23.9% of MSMEs own the premises they operate from, reducing the capability to provide real estate collateral for bank loans. Land and buildings as a proportion of total assets amount to a significant portion (over 50%) for only 4.1% of Iraqi MSMEs, with the average value for these MSMEs being 141.9 million ID. However, the average value of land and buildings for all MSMEs is only 9.3 million ID, severely restricting the capability to provide collateral for bank loans.<sup>8</sup>



<sup>7</sup> Erbil MSMEs reported the highest average values in most industry categories and Erbil had 13 of the 22 enterprises with assets over 5 billion ID.

<sup>8</sup> Businessmen can also use their own homes as collateral for loans. However, this may not always be acceptable to Iraqi banks in view of the difficulties of re-possessing residential real estate.

## Indebtedness

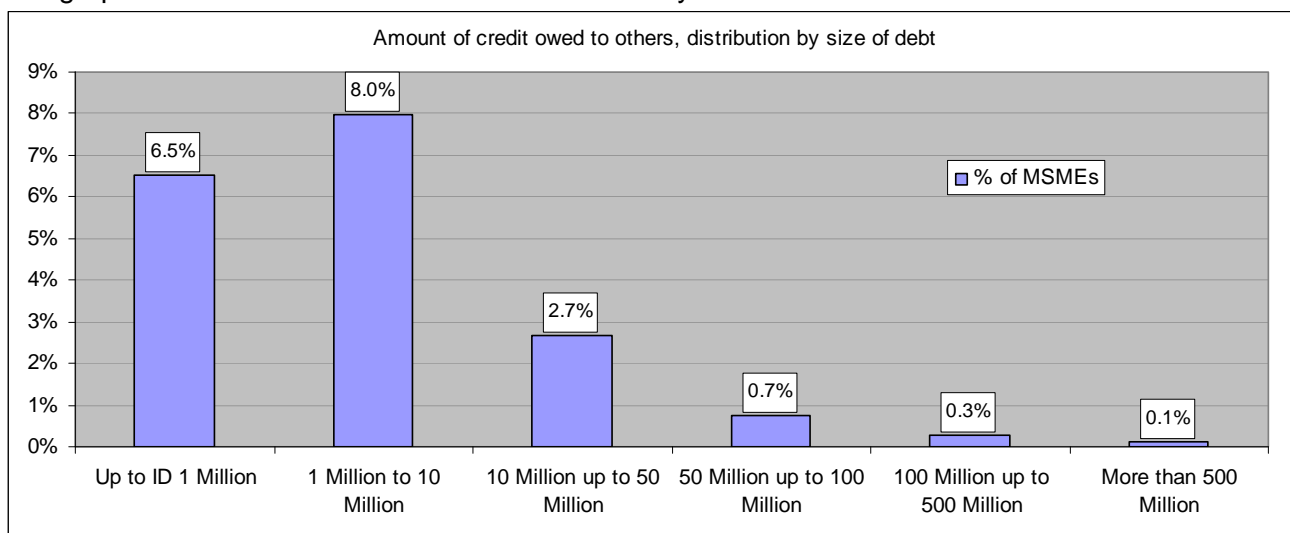
Iraqi MSMEs owe very little.

In answering the question 'what is the total amount owed by your business to others?' 81.65% have stated that they owe nothing.<sup>9</sup> Of those with debt, 36% owe less than 1 million ID and 79% owe less than 10 million ID.

The proportion of MSMEs with no indebtedness varied regionally from 50.6% in Erbil to 91.1% in Karbala and sectorally from 78% in manufacturing to 89.5% in energy sector.

Taking mid-interval value in the table below, the total debt of the interviewed MSMEs would come up to 40 billion dinars. The average debt is 3.5 million ID overall (19.3 million ID for those with debt). This indebtedness includes what is owed to families and friends who are far more frequent source of financing than money lenders, banks, etc.

The graph below shows the distribution of MSMEs by the size of their debt.



Regionally, the dispersion is wide. Average indebtedness for indebted enterprises varied from 59 million ID in Erbil down to 3.7 million ID in Muthanna.

### Indebtedness and asset ownership

Indebtedness should be seen in the context of the value of assets held by MSMEs. The total asset value of the MSMEs surveyed is 26 times more than their total indebtedness.

The average asset value, when looking only at those MSMEs which reported indebtedness, is 112.4 million ID, 5.84 times their indebtedness.

### Indebtedness and changes in turnover

The lowest levels of indebtedness were reported by MSMEs with stable level of sales. The levels of indebtedness of MSMEs reporting an increase in sales were higher.

<sup>9</sup> The answers excluded the value of advances from customers and suppliers and own savings invested in the businesses.

MSMEs which reported a decrease in sales over the previous year had the highest level of indebtedness in all debt brackets except the first one (below 1 million ID).<sup>10</sup> This suggests that credit may have been used not just to enable expansion but, even more so, to compensate for lagging performance in some enterprises.

<b>Changes in sales over the past year versus indebtedness</b>	up to ID 1 Million	1 Million to 10 Million	10 Million up to 50 Million	50 Million up to 100 Million	100 Million up to 500 Million	Remainder (no credit owed)
No change	6.9%	5.9%	1.7%	0.2%	0.1%	85.1%
Increase in sales	6.7%	8.6%	2.9%	0.8%	0.2%	80.8%
Decrease in sales	5.5%	10.8%	4.2%	1.6%	0.7%	76.9%

MSMEs reporting that their business was not profitable had a higher level of indebtedness in all asset size categories.<sup>11</sup>

### Indebtedness and industry sector

<b>Average debt, mn ID</b>	<b>Agri business</b>	<b>Construction</b>	<b>Manufacturing</b>	<b>Services</b>	<b>Wholesale, retail</b>	<b>Transport, storage</b>	<b>Hospitality</b>	<b>Communications</b>	<b>Energy</b>
All MSMEs	2.2 mn	5 mn	5.2 mn	1.8 mn	4.1 mn	5.6 mn	2.6 mn	1 mn	4.9
MSMEs with debt	13 mn	32 mn	23.6 mn	11 mn	19.5 mn	37.4 mn	17.5	5.9 mn	46.2

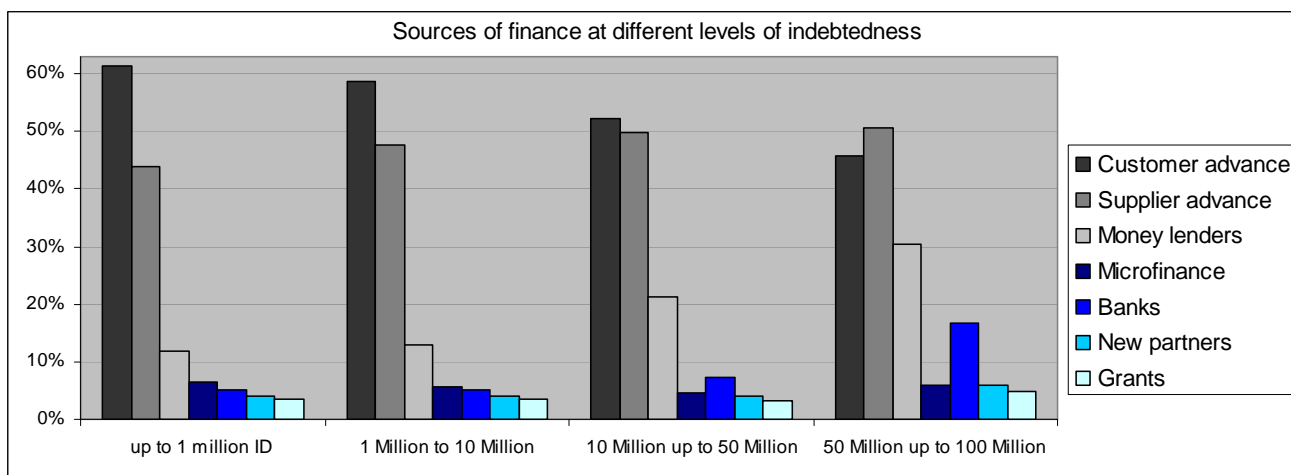
### Indebtedness and sources of finance

Results outlined in Section 1.4 ('Sources of Funding the Business') were recalculated for only those MSMEs that are currently indebted and the answers for 'frequent' and occasional' were weighted in proportion of 3:1. Family and friends accounted for most cases of indebtedness (70%), followed by money lenders (16.7%), banks (7%), microfinance (6.7%).

The graph below shows external financing sources for the four most common levels of indebtedness.

<sup>10</sup> The average debt for MSMEs in this category was 32 million ID versus 15.8 million ID for MSMEs reporting an increase in sales.

<sup>11</sup> Enterprises which stated that they were not profitable (a rather surprisingly low figure of 5.8%) had also a higher rate of financing from all sources with the exception of personal savings and customer advances. They also had a far greater proportion of enterprises reporting a decrease in sales turnover (47.6%) than the overall figure (23.4%).



The graph shows that for MSMEs with up to 10 million ID in indebtedness, microfinance is a more common source of finance than banks.

Customer advances, followed by supplier, is the most frequent source of financing except for the highest debt bracket.

Of note is the high frequency of financing through money lenders and the fact that this proportion increases for the more highly indebted companies.

Whether the high level of usage of money lenders as compared to banks is due to a preference on part of the borrowers (easier conditions offered by money lenders) or some other factor (for example, reluctance of banks to lend to small companies, particularly to already indebted enterprises) is a matter that requires further examination.

## 1.4 SOURCES OF FUNDING THE BUSINESS

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In reply to the question “which of the following sources do you use to fund your business most frequently?”:

1. business savings were mentioned by 82.5% of respondents, followed, far behind, by
2. own savings (30.6%),
3. customer advances (26.2%),
4. supplier advances (15%), and
5. family and friends (10.6%).

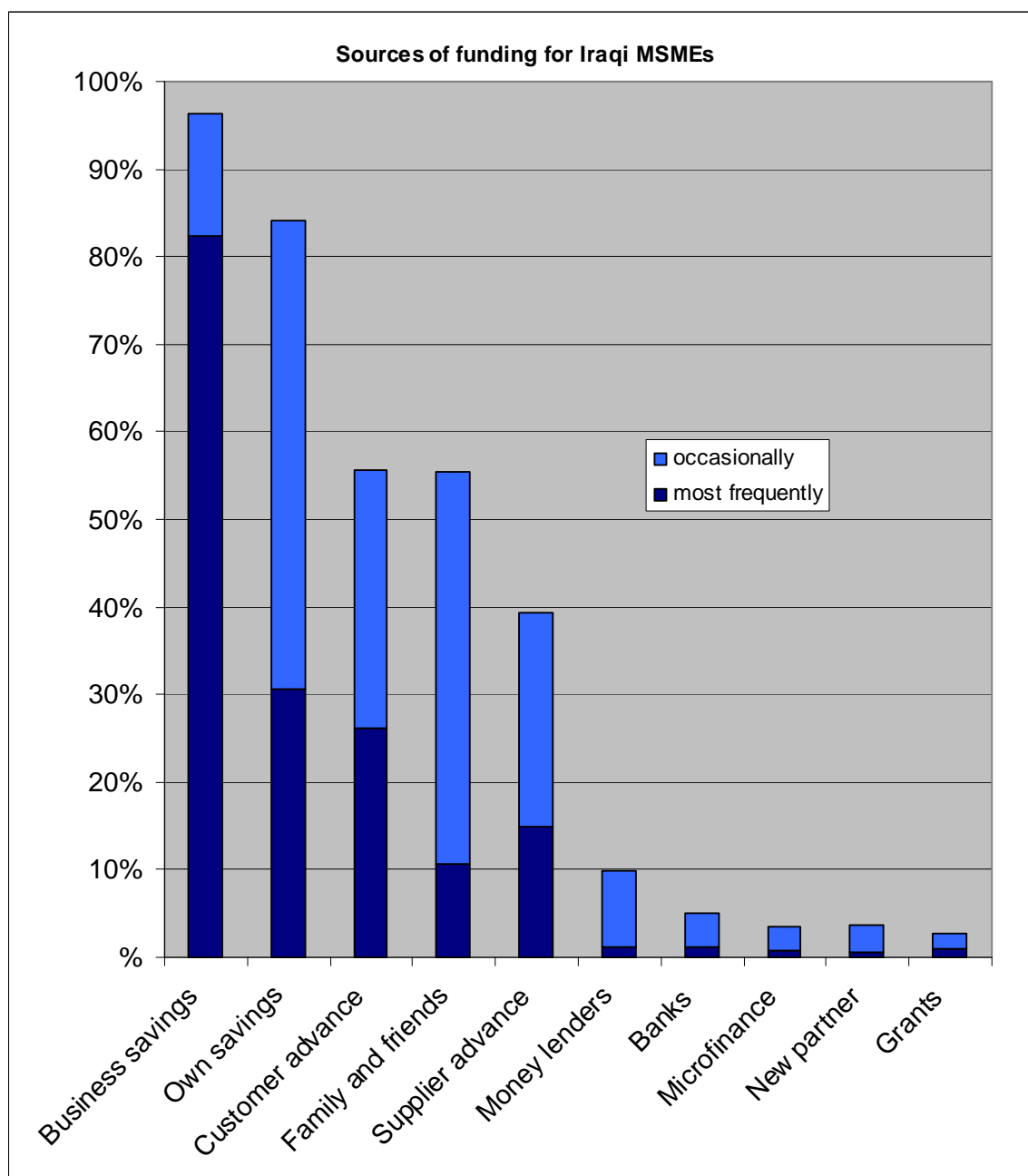
Other sources of finance figured only infrequently:

6. banks (1.1%),
7. money lenders (1.1%),
8. grants (0.9%),
9. microfinance (0.8%), and
10. new partners (0.5%).

In reply to the question “which of the following sources do you use to fund your business occasionally?”, the answers were:

1. own savings (53.3%),
2. family and friends (44.8%),
3. customer advances (29.5%),
4. supplier advances (24.3%),
5. business savings (13.9%),
6. money lenders (8.8%),
7. banks (3.8%),
8. new partners (3.1%),
9. microfinance (2.8%), and
10. grants (1.7%).

When taken together, ‘occasional financing’ answers affect the overall order of frequency so that ‘family and friends’ are in the fourth place and money lenders in the sixth place (see the graph below).



Comparison between the results for microfinance lending and lending by banks highlights the poor performance of banking in MSME lending. Microfinance is a new phenomenon in Iraq which started after 2003 and has been endowed with grants the value of which is far below the funds at the disposal of Iraqi banks<sup>12</sup>. Yet for those businessmen in the sample with current indebtedness, microfinance has been the source of frequent or occasional funding in almost as many cases as bank funding.

<sup>12</sup> Iraqi commercial banks held 38.6 trillion ID in deposits at the end of 2009 while their total lending amounted to 5.7 trillion ID.

### The most frequent source of financing

The Table below shows the distribution across various industries. There is no great difference between industries in the proportion of funds originating from:

- business savings,
- customer advances and
- supplier advances.

However, there is a disparity among industries when it comes to using own savings, with agribusiness showing the highest proportion (40.5%) while the energy sector is far lower (24%).

When it comes to external financing (banks, microfinance and money lenders), the construction industry is by far the most successful.

Most frequent source of finance (%)	Agri business	Construction	Manufacturing	Services	Wholesale, retail	Transport, storage	Hospitality	Communications	Energy
Business savings	82.6%	80.0%	83.0%	81.3%	84.6%	80.6%	84.7%	82.9%	82.4%
Own savings	40.5%	34.9%	31.1%	26.9%	29.4%	31.9%	29.3%	26.9%	24.0%
Customer advance	22.8%	26.2%	24.1%	26.2%	22.1%	25.4%	27.8%	31.1%	30.1%
Supplier advance	14.9%	18.1%	15.6%	12.8%	17.7%	12.1%	16.4%	14.9%	12.6%
Family and friends	13.5%	13.6%	10.9%	10.6%	10.4%	9.6%	10.5%	9.5%	7.2%
<b>Banks</b>	<b>.7%</b>	<b>3.9%</b>	<b>1.0%</b>	<b>.8%</b>	<b>.7%</b>	<b>2.0%</b>	<b>.7%</b>	<b>.3%</b>	<b>.7%</b>
<b>Money lenders</b>	<b>.6%</b>	<b>2.2%</b>	<b>1.4%</b>	<b>.8%</b>	<b>1.1%</b>	<b>1.0%</b>	<b>1.3%</b>	<b>.3%</b>	<b>1.1%</b>
Grants	.8%	.5%	.7%	.8%	.9%	1.0%	1.0%	1.0%	1.8%
<b>Microfinance</b>	<b>.7%</b>	<b>2.1%</b>	<b>.8%</b>	<b>.9%</b>	<b>.6%</b>	<b>1.0%</b>	<b>.3%</b>	<b>.3%</b>	<b>.4%</b>
New partner	.5%	1.0%	.4%	.8%	.8%	.2%	.7%	.0%	.4%

### Occasional source of financing

A subsidiary question inquired about occasional sources of finance. Here own savings and family and friends predominated. Almost without exception, the rankings were identical for all industries.

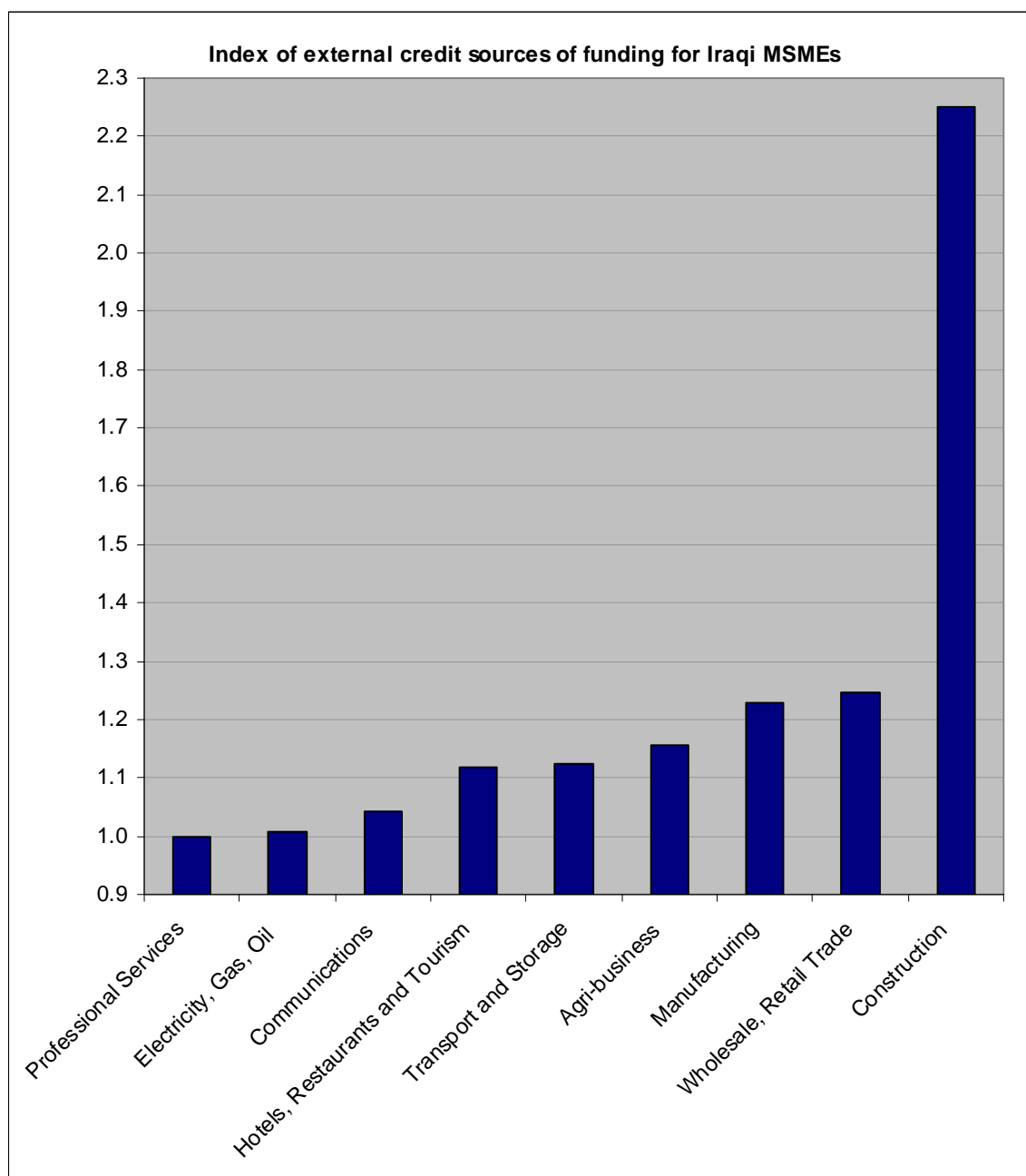
When it comes to obtaining funds from financial institutions (banks, microfinance and money lenders), the construction industry has been the most successful, followed by hospitality industry and communications. The greater engagement of the construction sector with banks is shown in a number of indicators shown throughout the text.

Occasional source of finance (%)	Agri business	Construction	Manufacturing	Services	Wholesale, retail	Transport, storage	Hospitality	Communications	Energy
Own savings	48.0%	49.2%	56.0%	54.0%	54.7%	49.0%	54.9%	55.7%	59.5%
Family and friends	51.9%	42.6%	49.0%	43.0%	45.1%	44.1%	41.7%	43.4%	42.3%
Customer advance	31.0%	33.0%	37.5%	25.0%	33.2%	29.8%	18.6%	27.0%	30.1%
Supplier advance	24.4%	28.5%	32.0%	19.7%	28.6%	21.8%	14.8%	23.2%	25.5%
Business savings	13.7%	14.8%	14.5%	14.3%	12.9%	17.2%	11.2%	13.3%	13.3%
<b>Money lenders</b>	<b>9.1%</b>	<b>13.2%</b>	<b>9.0%</b>	<b>7.6%</b>	<b>9.4%</b>	<b>7.7%</b>	<b>6.7%</b>	<b>7.3%</b>	<b>9.0%</b>
<b>Banks</b>	<b>3.7%</b>	<b>8.7%</b>	<b>3.2%</b>	<b>2.7%</b>	<b>3.5%</b>	<b>2.7%</b>	<b>5.0%</b>	<b>3.8%</b>	<b>2.2%</b>
New partner	2.9%	6.2%	1.8%	2.5%	2.7%	3.9%	3.0%	3.8%	1.1%
<b>Microfinance</b>	<b>2.5%</b>	<b>3.7%</b>	<b>3.1%</b>	<b>2.1%</b>	<b>3.4%</b>	<b>2.5%</b>	<b>2.8%</b>	<b>3.5%</b>	<b>1.8%</b>
Grants	1.5%	3.0%	1.2%	1.3%	2.0%	1.7%	1.7%	2.5%	.4%

### Summary index of external sources of financing for Iraqi MSMEs

This index looks at three modes of external financing: banks, microfinance institutions and money lenders, aggregating 'frequent' and 'occasional' source of financing. The least financed industry (services) is the basis of the index at 1.00.

It can readily be seen that construction industry is by far the most successful sector in obtaining access to funds.

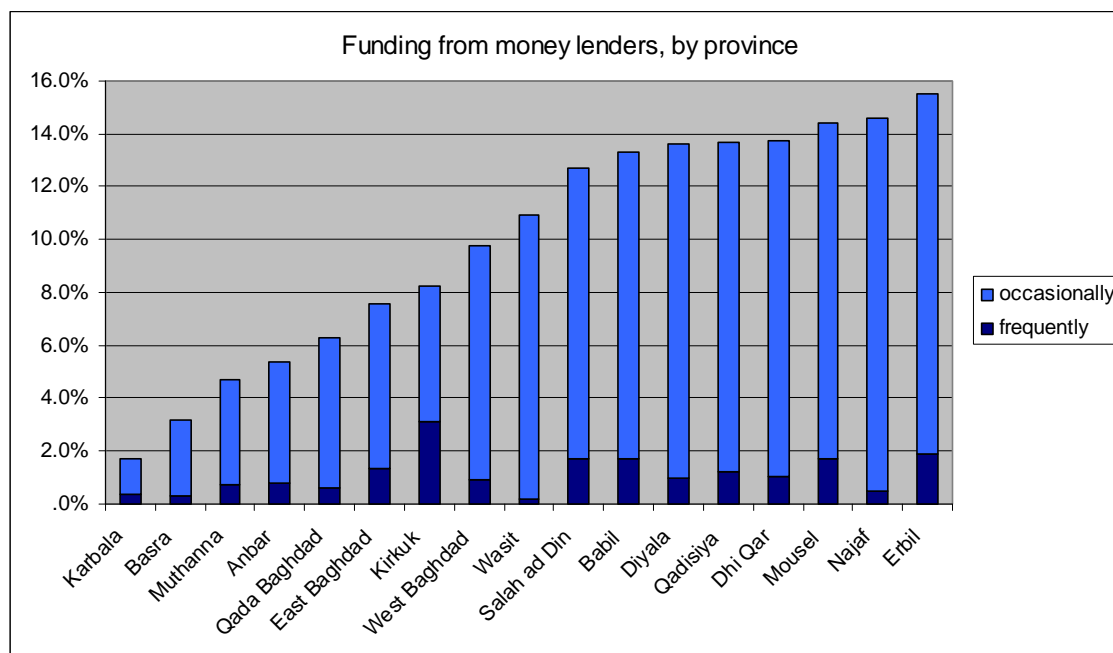


Note that the index does not take into account the amount of indebtedness<sup>13</sup>; it measures the frequency of access.

Looking at the **amount** of indebtedness, the top performer is the energy sector with average indebtedness of 46.2 million ID followed by transport and storage with 37.4 million ID and construction with 32 million ID. Last places are taken up by communications (5.9 million ID), the services industry (11 million ID) and agribusiness (13 million ID).

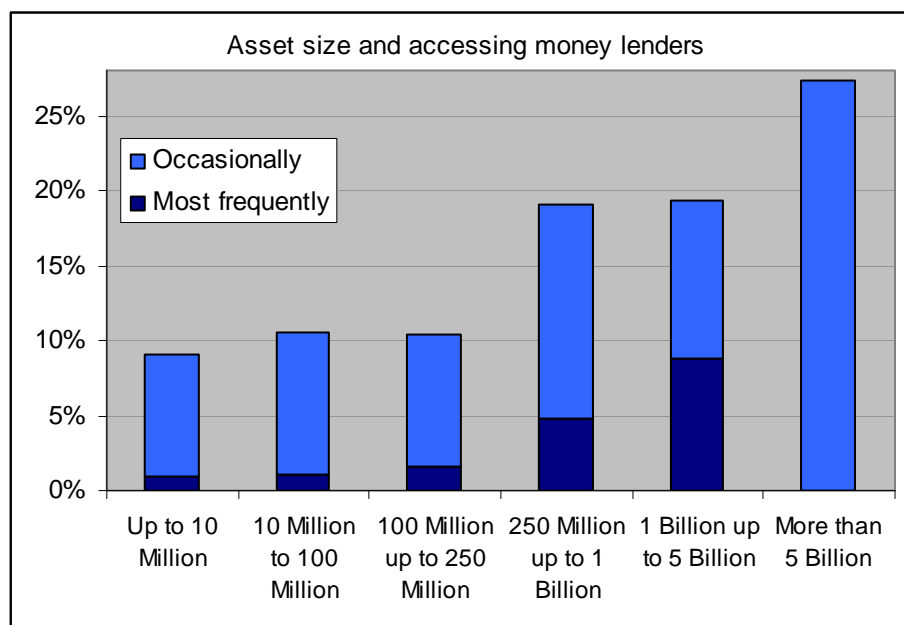
<sup>13</sup> Only very few MSME owners (80) provided information about the size of loan they have taken out. The average value was just above 19 million ID.

## 1.5 MONEY LENDERS

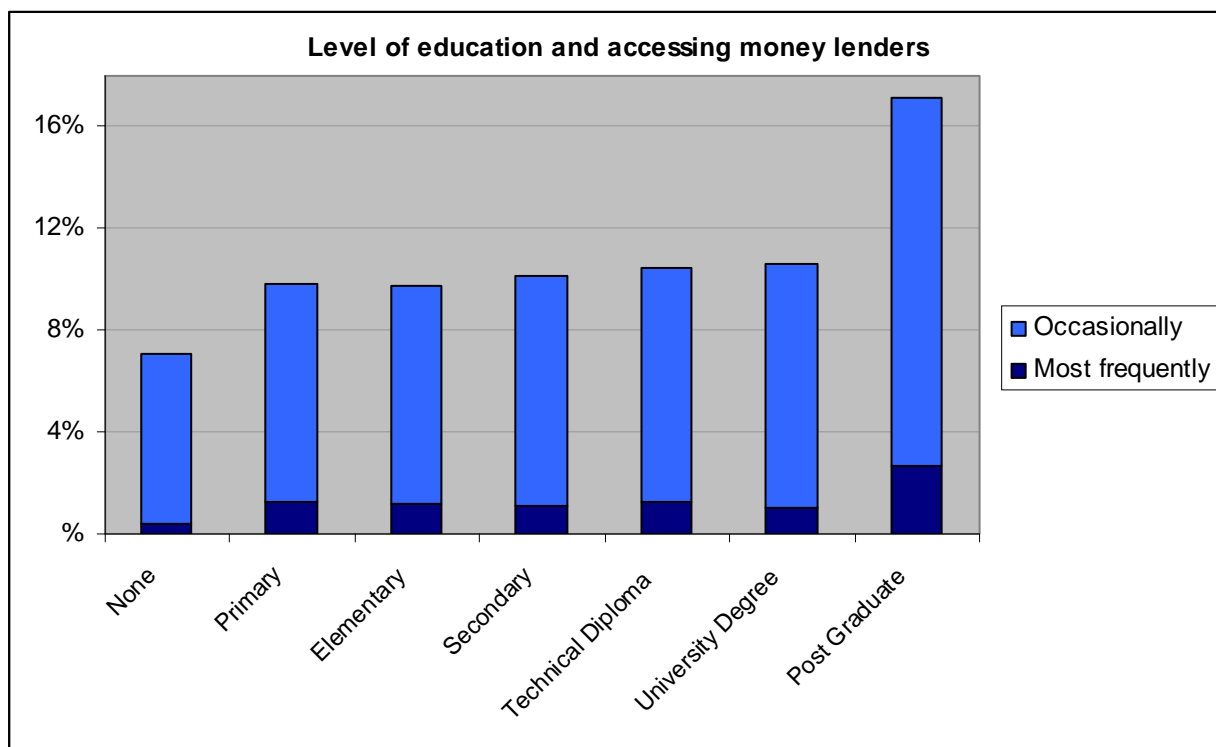


MSMEs in some provinces (e.g. Babil and Qadisiya) were scoring high on funding from all sources of external financing, including money lenders, while other provinces scored low on all sources of external financing (Karbala and Basra). Only a minority of provinces (Erbil, Najaf, Dhi Qar) showed high percentage accessing money lenders together with a low percentage of MSMEs accessing banks and microfinance. The evidence therefore does not allow an unambiguous assertion that businessmen turn to money lenders only because they find finance from other venues inaccessible.

Money lenders were not being accessed just by small businesses. In fact, whether measured by the number of employees or by asset size, larger companies were funded by money lenders more frequently than small companies.



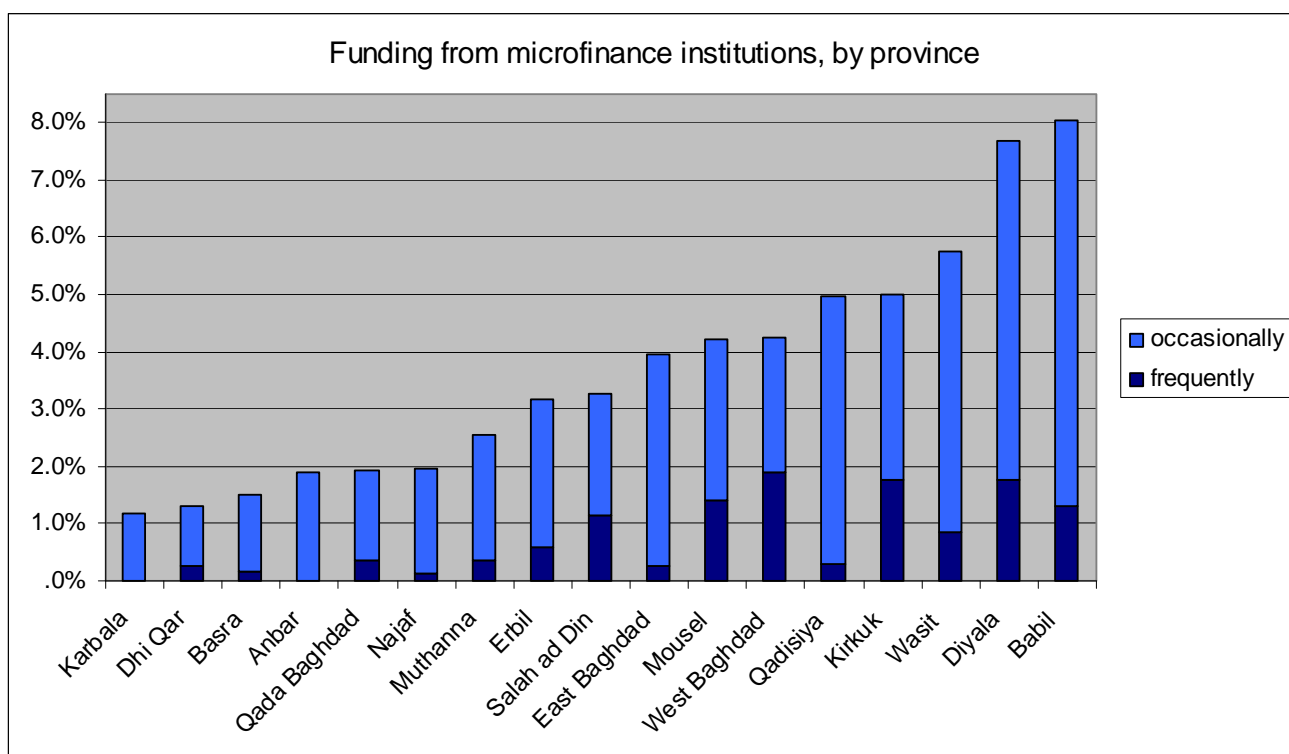
Contrary to expectations, use of money lenders was not restricted to less sophisticated businessmen.



Across all categories of enterprise size, money lenders were a more frequent source of funds than banks (11% versus 4.85%). Little information is publicly available on the terms and conditions provided by money lenders in Iraq, a subject that deserves more attention.

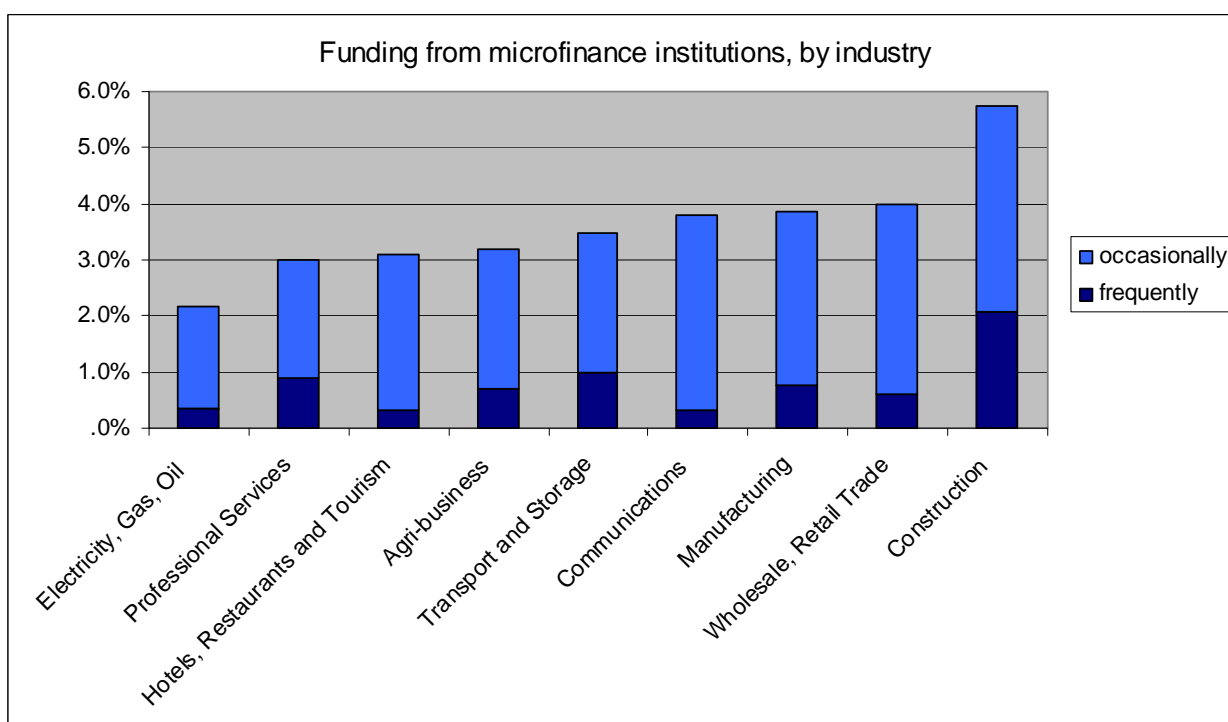
## 1.6 MICROFINANCE FUNDING

### By province



Overall average for frequent access to microfinance was 0.8%, overall average for occasional access to microfinance was 2.9%. The lowest levels of access were reported in Karbala and Dhi Qar. The provinces of Diyala and Babil showed the best results. Dohuk, Sulamaniya and Missan were not surveyed.

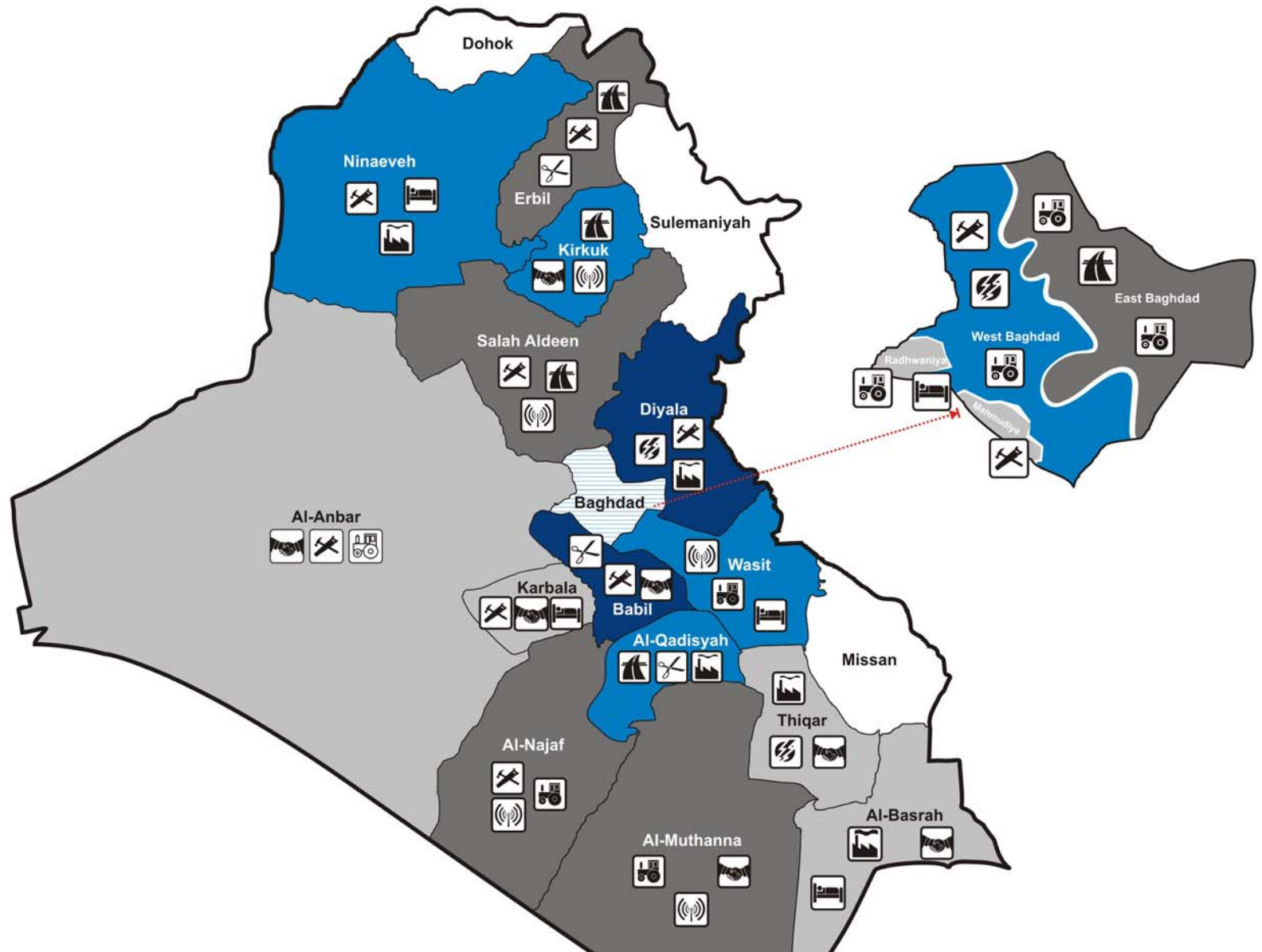
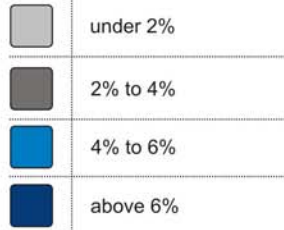
### By industry



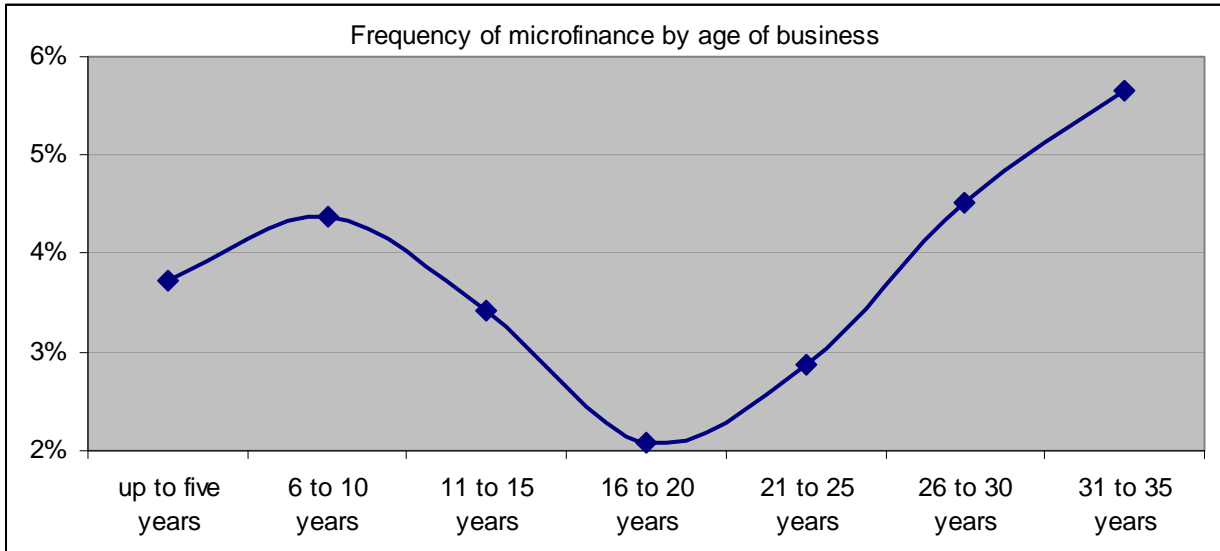
Taking the combined results for frequent and occasional financing and looking at results for different industries at provincial level shows that industry ranking differs from province to province. For each surveyed area, the Table and the map below also shows the 3 industries which report the most frequent access to microfinancing.

<b>Usage of microfinance, %</b>	Industry 1	Industry 2	Industry 3
Anbar, 1.9%	Trade	Construction	Agribusiness
Babil, 8%	Construction	Services	Trade
Basra, 1.5%	Hospitality	Manufacturing	Trade
Dhi Qar, 1.3%	Energy	Trade	Manufacturing
Diyala, 7.7%	Construction	Energy	Manufacturing
East Baghdad, 3.9%	Agribusiness	Transport	Agribusiness
Erbil, 3.2%	Construction	Transport	Services
Karbala, 1.2%	Construction	Hospitality	Trade
Kirkuk, 5%	Transport	Communications	Trade
Mosul, 4.2%	Manufacturing	Hospitality	Construction
Muthanna, 2.6%	Communications	Agribusiness	Trade
Najaf, 2%	Communications	Agribusiness	Construction
Qada Baghdad, 1.9%	Construction	Hospitality	Agribusiness
Qadisiya, 5%	Manufacturing	Transport	Services
Salah ad Din, 3.3%	Construction	Transport	Communications
Wasit, 5.8%	Hospitality	Agribusiness	Communications
West Baghdad, 4.3%	Agribusiness	Construction	Energy

Per cent of MSMEs using Microfinance Loans

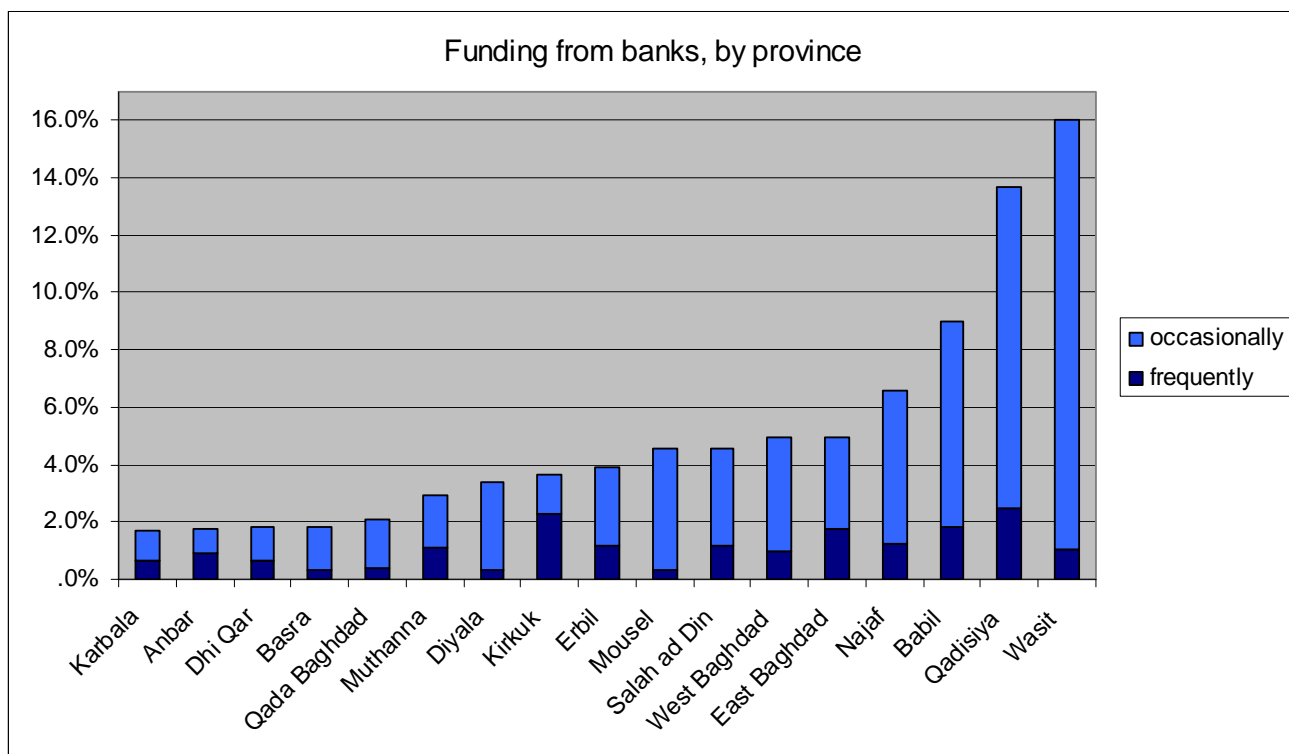


**By length of time in business**

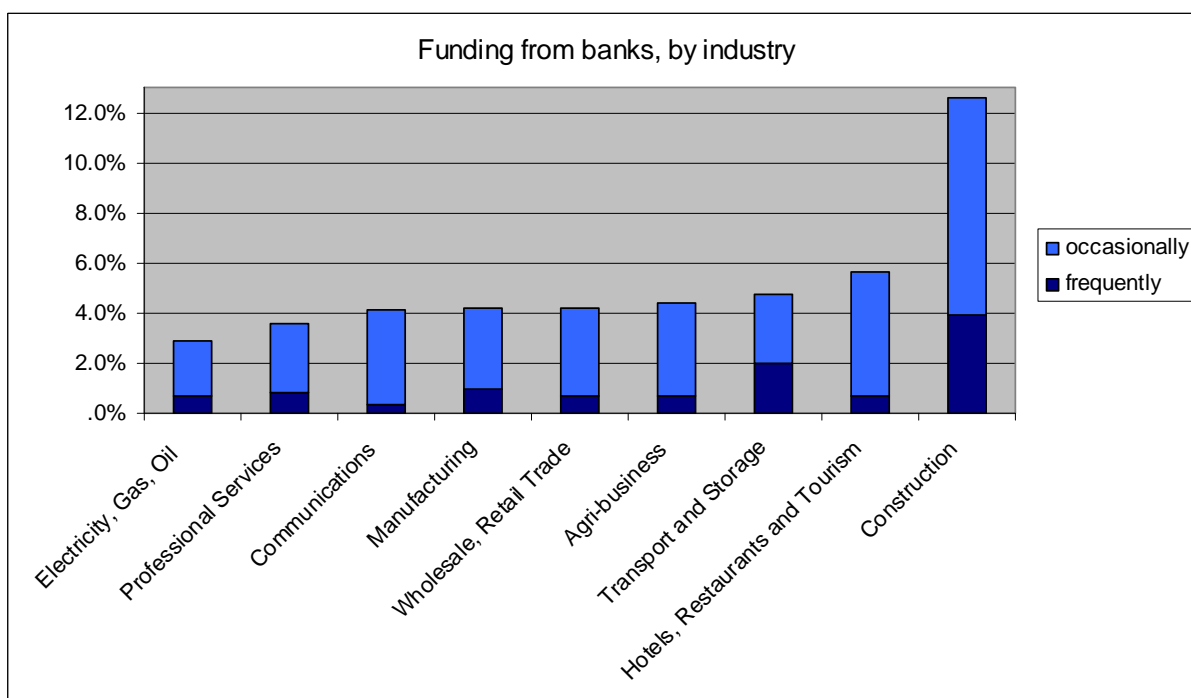


## 1.7 BANK FUNDING

The ranking for provinces is similar as for microfinance institutions. Looking at the frequent and occasional funding combined, Wasit, Qadisiya, Babil and Diyala are the top four while Anbar, Basra, Dhi Qar and Karbala are the bottom four provinces.



With bank funding, hospitality industry and agribusiness rank higher than with microfinance while wholesale and retail does worse. Energy sector remains the least frequently funded for both microfinance and bank funding group while construction is at the top of the tables for both banking and microfinance.



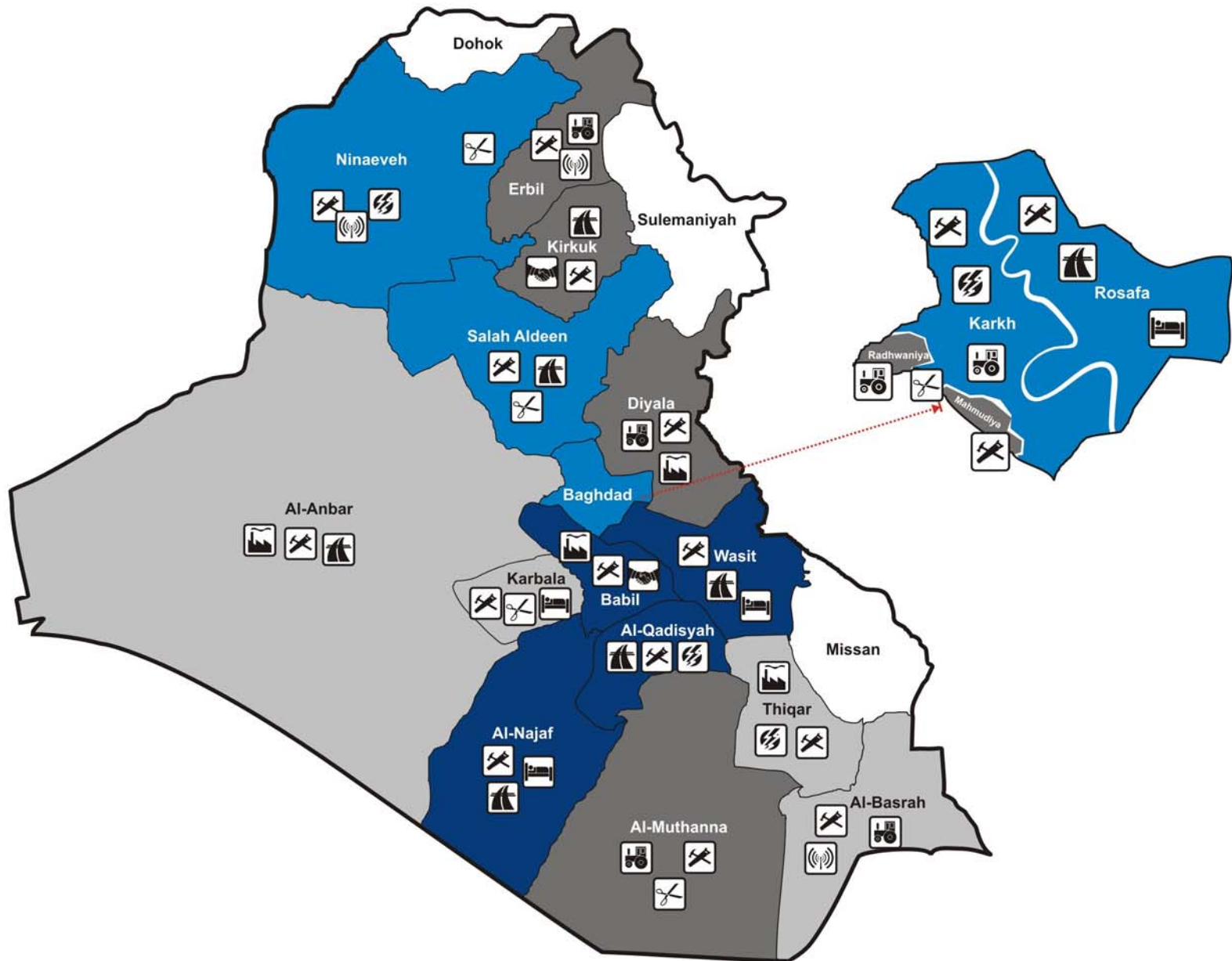
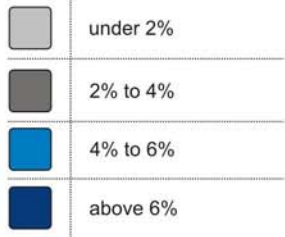
## 1.8 BANK FUNDING DISAGGREGATED BY INDUSTRY AND REGION

The map on the next page shows the frequency of access to bank financing in various provinces in Iraq. Geographically, the last three ranked were Basra, Anbar and Karbala. The provinces of Wasit, Qadisiya and Babil showed the best banking results. Dohuk, Sulemaniya and Missan were not surveyed.

Taking the combined results for frequent and occasional financing and disaggregating the industry results to the regional level shows divergence among the industry sectors in different provinces in the extent of bank financing. For each surveyed area, the Table below and the map also shows the 3 industries which report the most frequent access to bank financing.

<b>Usage of bank finance, % (ascending)</b>	Industry 1	Industry 2	Industry 3
Karbala, 1.7%	Construction	Hospitality	Services
Anbar, 1.79%	Construction	Transport	Manufacturing
Dhi Qar, 1.83%	Construction	Energy	Manufacturing
Basra, 1.84%	Construction	Communications	Agriculture
Baghdad Qadas, 2.1%	Construction	Agriculture	Services
Muthanna, 2.9%	Services	Agriculture	Construction
Diyala, 3.37%	Construction	Manufacturing	Agriculture
Kirkuk, 3.65%	Trade	Construction	Transport
Erbil, 3.88%	Communications	Construction	Agriculture
Mosul, 4.53%	Construction	Communications	Energy
Salah ad Din, 4.56%	Construction	Services	Transport
West Baghdad, 4.93%	Construction	Agriculture	Energy
East Baghdad, 4.94%	Transport	Construction	Hospitality
Najaf, 6.55%	Construction	Hospitality	Transport
Babil, 8.97%	Construction	Trade	Manufacturing
Qadisiya, 13.71%	Transport	Construction	Energy
Wasit, 16.01%	Transport	Hospitality	Construction

Per cent of MSMEs using bank finance



The highest recorded proportions for each industry sector are recorded below, in ascending order:

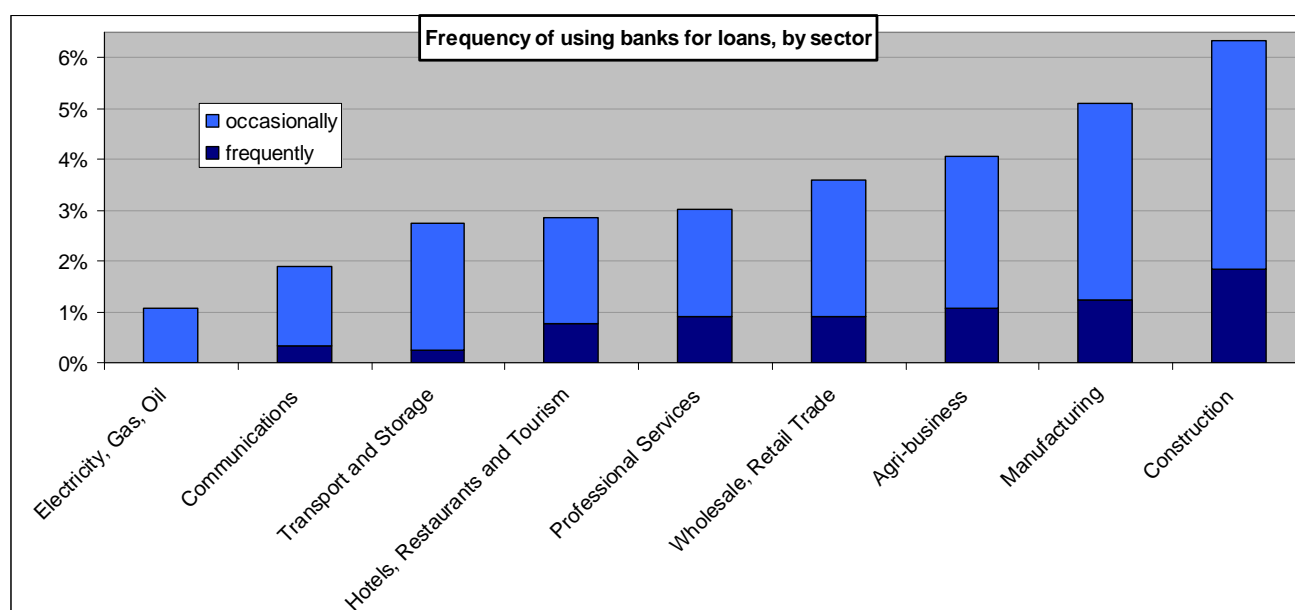
- In **manufacturing**, the highest proportion of bank financing was reported in Qadisiya - 11.8% of manufacturing MSMEs.
- In **agribusiness**, the highest proportion of bank financing was reported in Wasit - 17.8%.
- In **wholesale and retail trade**, the highest proportion of bank financing was reported in Wasit - 18%.
- In **communications**, the highest proportion of bank financing was reported in Wasit - 18.8%.
- In **services**, the highest proportion of bank financing was reported in Qadisiya - 19%.
- In the **hospitality sector**, the highest proportion of bank financing was reported in Wasit - 20.5%.
- In the **energy sector**, the highest proportion of bank financing was reported in Qadisiya - 22.2%.
- In **transport and storage**, the highest proportion of bank financing was reported in Qadisiya - 40%.
- In the **construction sector**, the highest proportion of bank financing was reported in Najaf - 40%.

## 1.9 OTHER INDICATORS OF EXTERNAL FINANCING

In **question 59**, respondents were asked which bank services they use, the options being deposit accounts, money transfers, loans, trade financing (letters of credit), overdrafts, asset financing (leasing) and real estate financing. In this section, results for the question about bank loans are shown.

The lower percentages for 'bank loans' (3.83% overall) as compared to 'bank finance' (4.85% overall) may be ascribed to the fact that loans are only one of the means through which a bank can finance an MSME, the other possibilities being Islamic co-financing or overdrawing on an account.

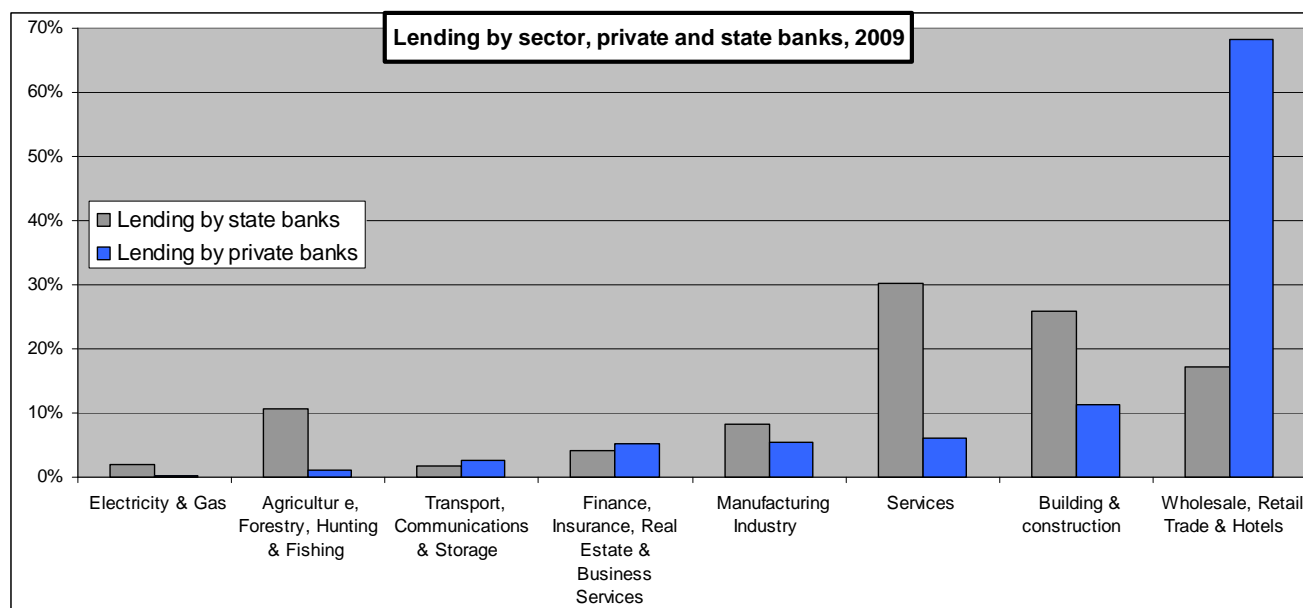
As with bank financing, the construction industry has the highest score for both 'frequently' and 'occasionally' while the energy sector is last.<sup>14</sup>



Geographically, Babil and Qadisiya retain their top places but Muthanna now falls into middle of the rankings. Anbar, Karbala and Basra retain their places at the end.

**Central Bank of Iraq:** In its 2009 Statistical Overview, CBI shows commercial bank lending to various industries (both private and state enterprises, with the latter receiving only 13% of the loans). Of the 5.7 trillion ID in loans, the largest volume of funds (34.3%) goes to hospitality and wholesale and retail sector, followed by services (22.1%) and building and construction (21%). The Table below shows the proportions lent to various industries by state and private banks.

<sup>14</sup> However, it should be remembered that the average indebtedness is the highest in the energy sector. In other words, while the table records the frequency of funding, no extrapolation as to the extent of funding can be made.



It can be seen that the industries receiving the largest **volume** of bank loans overall, as reported by CBI, are in some cases different from those which show the highest **frequency** of bank loans in Market Assessments.

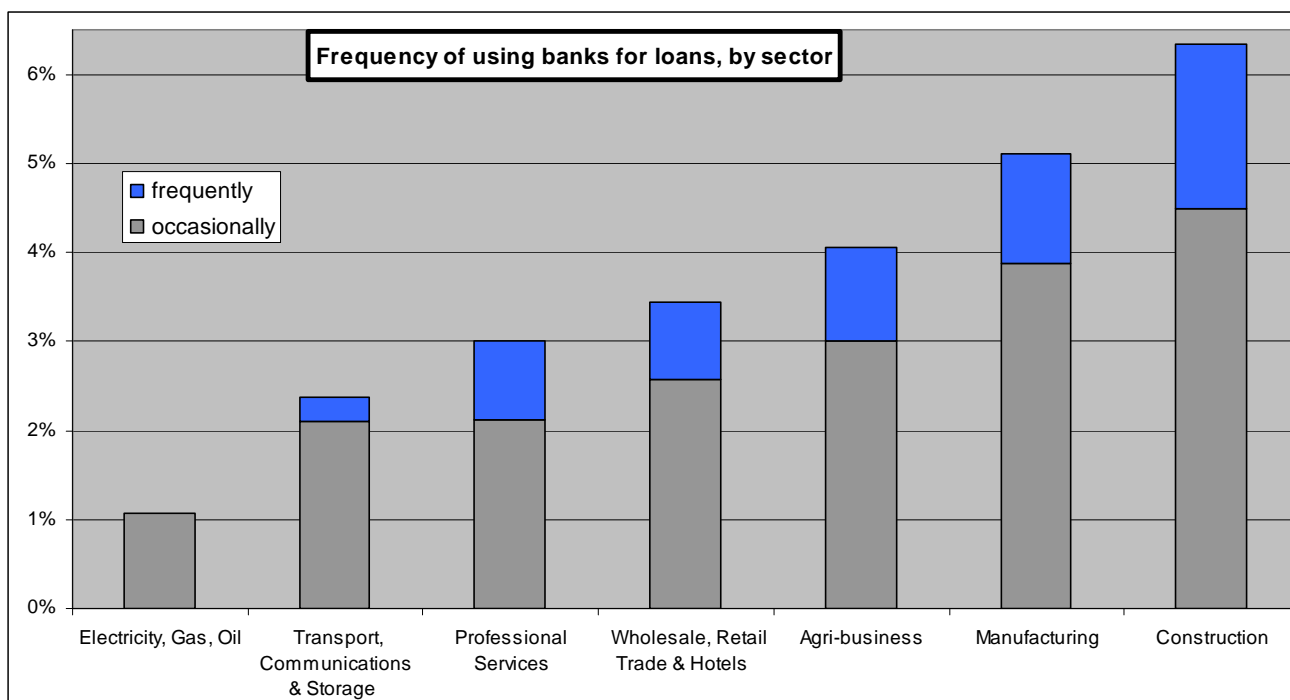
For example, MSMEs in the hospitality and wholesale and retail sectors, which receive a lion's share of overall bank loans in the CBI table, do not show the highest percentage of using bank loans among the industries surveyed in Market Assessments. There are several possible reasons for this.

One is that the number of wholesale and retail enterprises is so large (informal estimates put the overall percentage of such firms as high as 70%) that even a large volume of loans would be spread thin within this industry (CBI statistics show the volume of funds rather than the number of loans).<sup>15</sup>

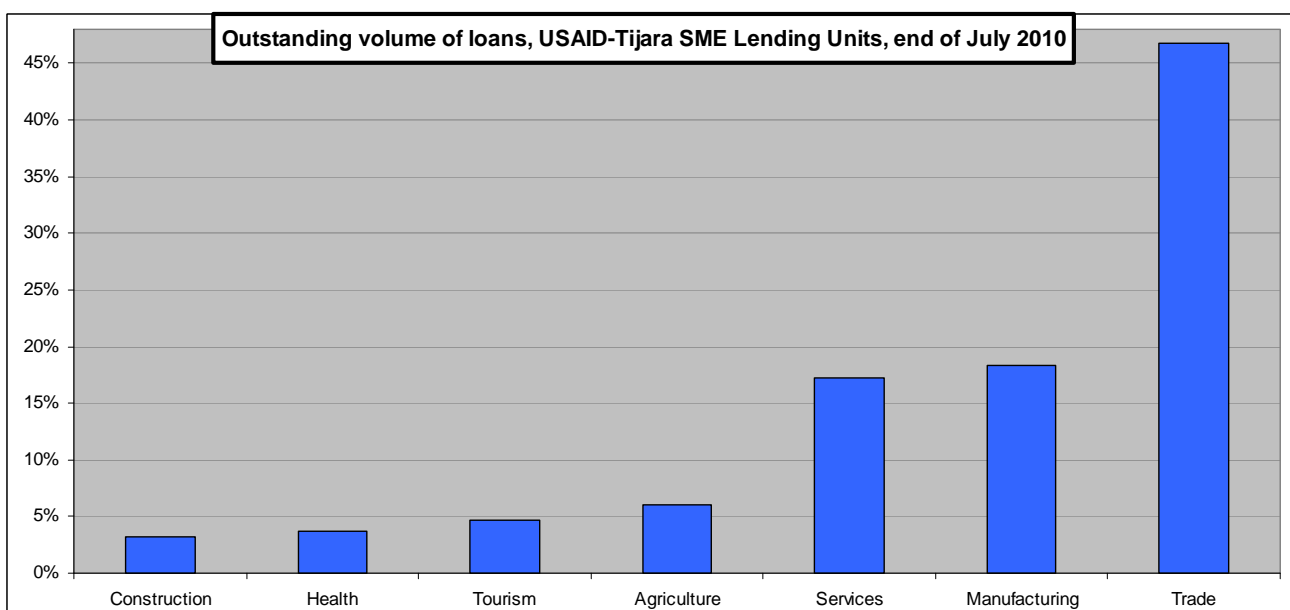
CBI's industry categories are somewhat different from the division used in Market Assessments. To make the comparison easier, industry categories in the Table below have been re-arranged to make the Market Assessments categories correspond more closely with the classification used by the Central Bank.

<sup>15</sup>

It is not known what proportion of loans reported by the Central Bank were MSME loans. A review of USAID-*Tijara*'s partner banks has shown that SME loans accounted for 4.83% of their lending portfolio in 2009. Applying this proportion to the total credit provided to the private sector by private banks (1.9 trillion ID) would yield 91 billion ID (\$78.6 million) in SME loans. This amount is at the upper bound of probability since private banks participating in the SME Lending Units program can be presumed to have a higher proportion of their portfolios devoted to SME lending. However, the proportion of SME lending by state banks is not known (state banks' lending to the private sector is nearly 1.5 times higher - 2.74 trillion ID).



**USAID-Tijara:** A comparison can also be made with SME lending patterns exhibited by SME Lending Units participating in USAID-Tijara’s program. Here, lending to the retail sector, together with tourism, dominates with nearly 50%, although it is rather less than CBI’s 68.2% of all private banks’ loans going to these two sectors. The most striking difference between the results of Market Assessments and USAID-Tijara’s lending pattern is the very low volume of loans going to the building and construction sector in the case of MSME lending facilitated by banks cooperating with USAID-Tijara..



## 1.10 EXPLANATION FOR DIFFERENCES IN LEVEL OF BANK FINANCING

The size of the enterprise (measured by employment size, turnover and assets) will be shown to have a strong correlation with access to bank finance. Many of the other aspects correlated with MSMEs' access to finance cited in this section may appear to be a side effect of the size of the enterprise. After all, it is the larger enterprises which tend to use accountants, establish business accounts, etc. The costs of doing so are more easily borne by larger MSMEs.

Nevertheless, that is not the full story. For example, MSMEs with a business bank account are 13 times more likely to have had access to bank finance as opposed to those which do not have such an account. When we disaggregate this statistic we can see that this disproportion holds for enterprises at all levels of asset size (see the table below).

Enterprises in the smallest asset size (up to 10 million ID) are twelve times more likely to have had bank funding if they have a business bank account. Admittedly, very few of them do have such an account (4.2%) but if they do have one, their odds of bank financing are much higher.

In fact, a small company with assets of under 10 million ID and a business bank account was more likely to have had access to bank financing than a company with assets between 100 mn and 250 mn ID without such an account.

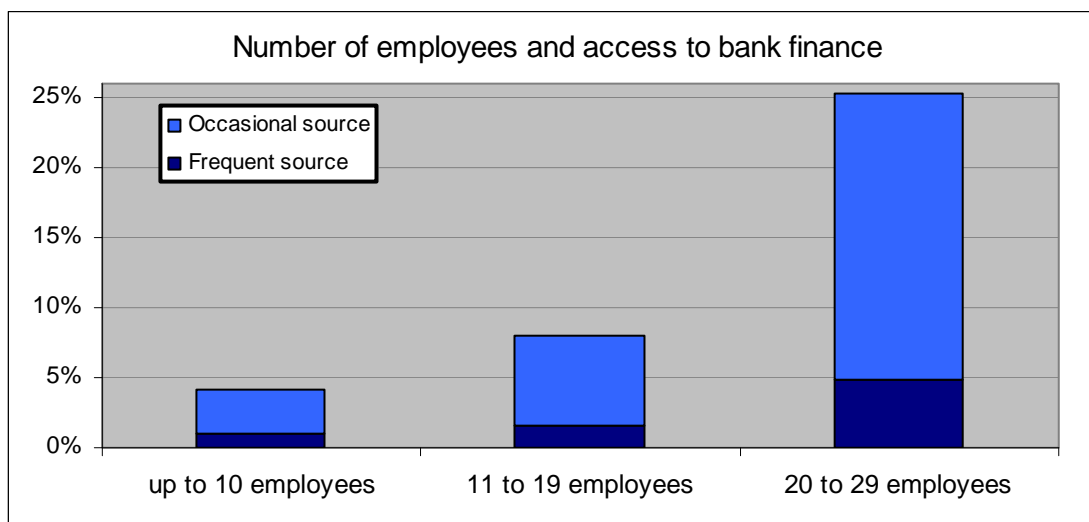
<b>I. Business bank account and banks as a source of finance (assets up to 10 million ID)</b>	does have a business bank account (4.2% of the category)	does not have a business bank account (95.8% of the category)
Frequent source	3.2%	0.4%
Occasional source	15.6%	1.3%
Together	18.8%	1.7%
<b>II. Business bank account and banks as a source of finance (assets 10 mn ID to 100 mn ID)</b>	does have a business bank account (11.2% of the category)	does not have a business bank account (88.9% of the category)
Frequent source	3.9%	0.4%
Occasional source	19.6%	1.6%
Together	23.5%	2%
<b>III. Business bank account and banks as a source of finance (assets 100 mn ID to 250 mn ID)</b>	does have a business bank account (30.8% of the category)	does not have a business bank account (69.2% of the category)
Frequent source	8.5%	0.8%
Occasional source	24.1%	3.3%
Together	32.5%	4.1%

One can therefore make a plausible supposition that an enterprise, whatever its size, will increase its prospects of bank financing by adopting more formal appurtenances such as a registration with the government, creation and auditing of its accounts as well as conducting its financial transactions through a bank.

### Size - employees

Looking at the size of the MSME as a factor, the relationship is predictable: the larger the size of the enterprise, the higher the probability that it will have received bank financing. The table below shows that enterprises with 20 to 29 employees are nearly 5 times more likely to have access to bank financing. However, it needs to be noted that this is a small minority of MSMEs (185 cases, 1.6% of the sample).

<b>Employment size and banks as a source of finance</b>	up to 10 employees	11 to 19 employees	20 to 29 employees
Frequent source	0.96%	1.6%	4.9%
Occasional source	3.19%	6.43%	20.37%



For the sake of comparison with the employment size classification used by Market Assessments reports, we also looked at the employment size and the likelihood of obtaining bank financing for micro, small and medium enterprises:

<b>Employment size and banks as a source of finance</b>	micro up to 2 employees	small 3 to 9 employees	medium 10 to 30 employees
Frequent and occasional source, together	2.7%	4.2%	9.9%

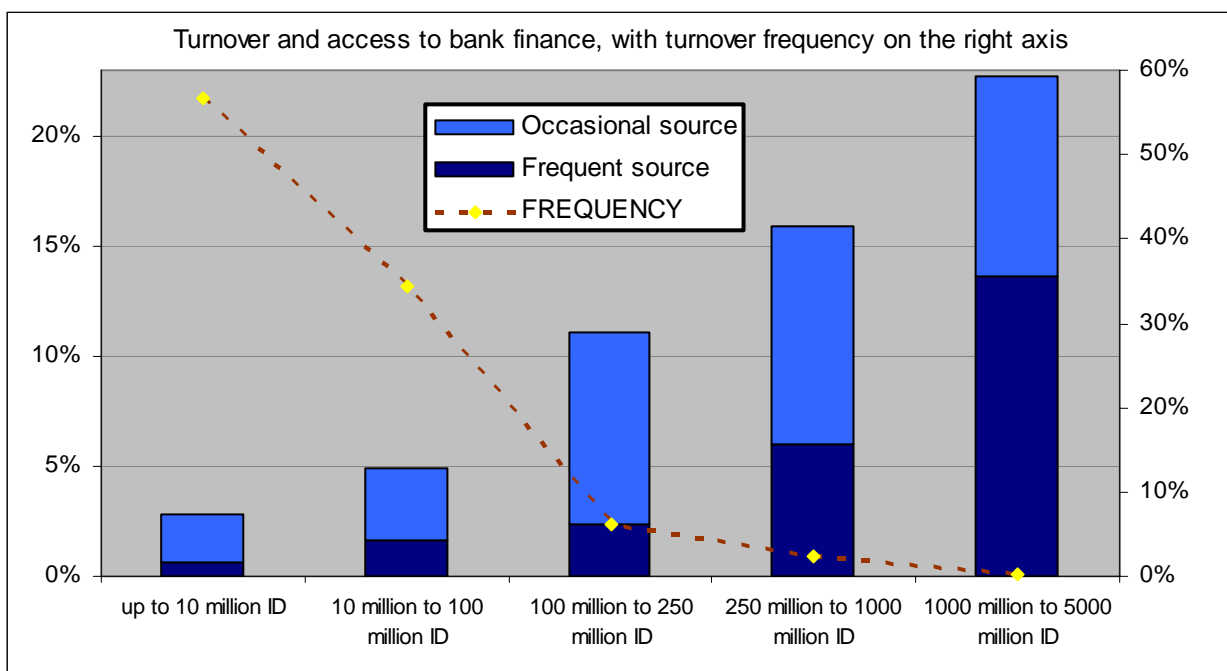
In the case of microfinance, the relationship between size and likelihood of obtaining a loan is much weaker.

<b>Employment size and microfinance as a source of finance</b>	up to 10 employees	11 to 19 employees	20 to 29 employees
Frequent source	0.7%	1.2%	1.6%
Occasional source	2.8%	3.1%	4.3%

Note that no discernible linear relationship with employment size was found for other modes of financing (money lenders, business savings, family and friends, etc).

### Size - turnover

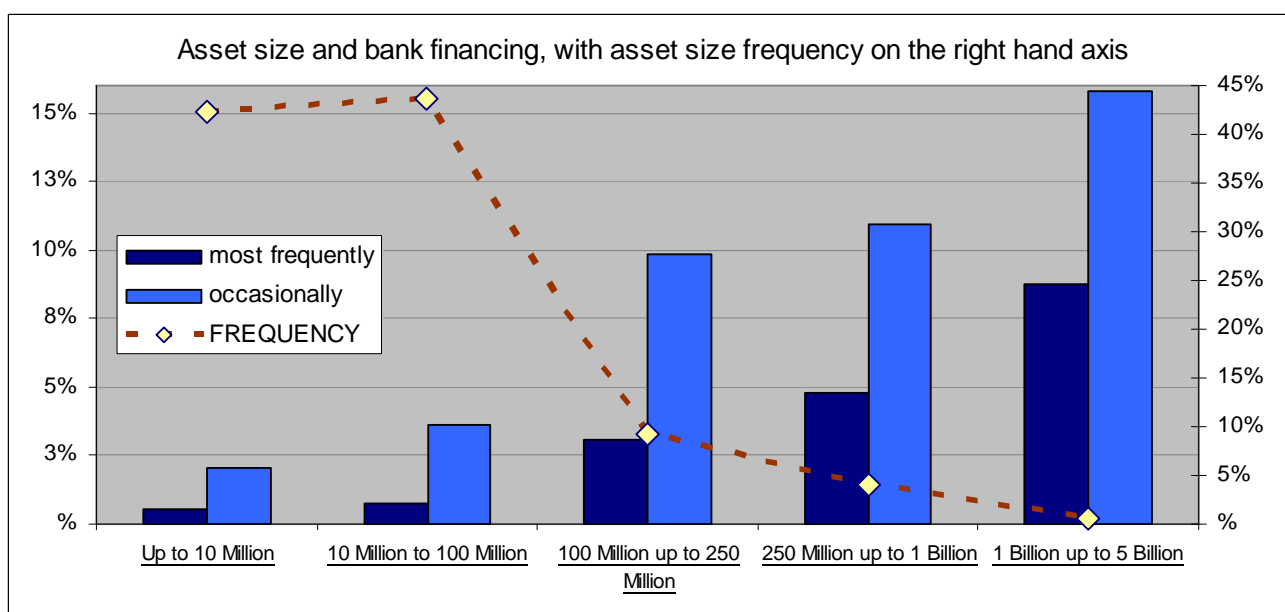
Again, there is again a strong correlation between bank financing and size.



Additionally, enterprises that report an increase in turnover in the last financial year show a higher rate of access to bank financing (7%) compared to MSMEs reporting no change (3.8%) or decline (3.6%).

### Size - assets

Taking assets as an indicator of size, there is again a strong correlation between bank financing and size.



Asset size and employee numbers were also a strong determinant of whether an MSME gets access to other types of external credit (with the exception of microcredit):

<b>Asset size and source of finance</b>	up to 10 million ID	10 million to 100 million ID	100 million to 250 million ID	250 million to 1000 million ID <sup>16</sup>	1000 million to 5000 million ID	above 5000 million
Frequent and occasional use, <b>money lenders</b>	9.1%	10.6%	10.3%	19.1%	19.3%	27.3%
Frequent and occasional use, <b>trade finance</b>	2.1%	3.5%	6.9%	11.9%	31.6%	22.7%
Frequent and occasional use, <b>overdraft</b>	3.6%	3.6 %	8.2%	6.4%	8.8%	18.2%
Frequent and occasional use, <b>asset finance</b>	2.5%	3.3%	4.8%	5.4%	14%	4.5%

Larger MSMEs may be more frequent recipients of external financing either because banks prefer dealing with larger companies (perhaps because larger collateral is available), or perhaps because larger companies can devote more resources to administration and lobbying for loans, or possible for both reasons.

Enterprise size is not a factor which is easily influenced by MSME owners in the short run, other than by taking on new business partners or merging with another MSME. Evidence shows that this may indeed be the strategy adopted by Iraqi MSMEs – higher asset value MSME are much more likely to be partnerships rather than have sole owner.

<b>Asset size and type of ownership</b>	up to 10 million ID	10 million to 100 million ID	100 million to 250 million ID	250 million to 1000 million ID	1000 million to 5000 million ID	above 5000 million
Sole owner	88%	82.1%	77.3%	67.8%	54.4%	63.6%
Partnership	12%	17.9%	22.7%	32.2%	45.6%	36.4%

### Use of financial services

While the data does not provide an answer to the question whether increase in the size of business leads to more sophistication in the use of financial services or the other way around, the correlation between the two is clear. Larger enterprises use banking and accounting services more often:

<b>Asset size and use of financial services</b>	up to 10 million ID	10 million to 100 million ID	100 million to 250 million ID	250 million to 1000 million ID	1000 million to 5000 million ID	above 5000 million
Business bank account	4.2%	11.2%	30.7%	40.5%	70.4%	54.5%
External audit	3.9%	6.0%	12.7%	19.8%	33.3%	50%
Using banks for money transfers	5.5%	11.8%	25.5%	30.9%	54.4%	63.6%

<sup>16</sup> Less than 5% of MSMEs had assets exceeding 250 million ID.

Equally clear is the relationship between the usage of financial services provided by banks and MSMEs' access to bank finance.

For example, the owners were asked how they pay they bills. Of those who pay in cash (87.5% of MSMEs), 5.1% have had access to bank financing. Among those who use bank transfers (only 5% of MSMEs), this percentage was 26.4%. Among those who use checks (only 3.8% of MSMEs), this percentage was 38.9%.

### Accounting and financial reporting

MSMEs with external audit were 3.63 times more likely to be recipients of bank financing than those that were not so audited (15% versus 4.1%).

MSMEs which frequently compiled their balance sheets and income statements were 4.8 times more likely to be recipients of bank financing than those that did not (12.7% versus 2.7%).

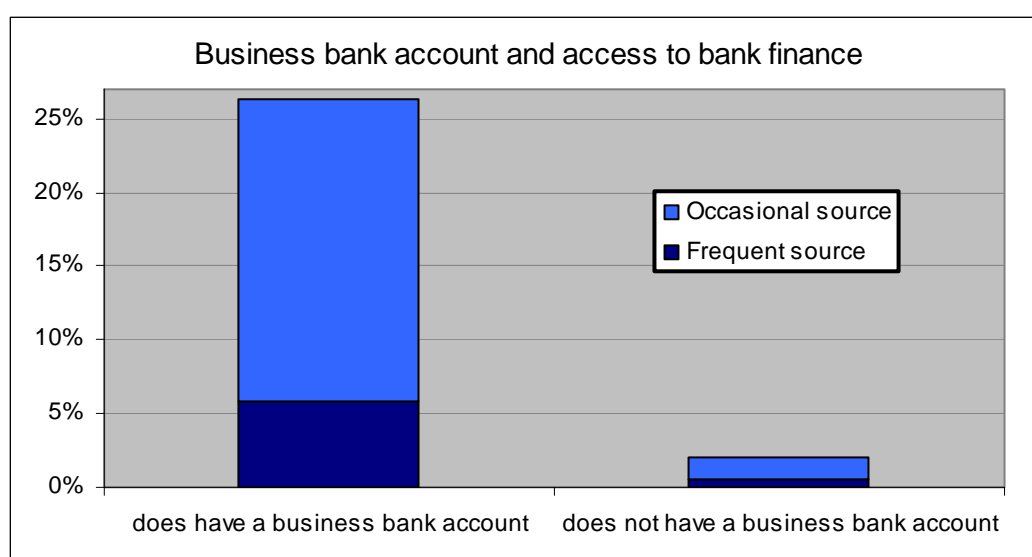
MSMEs which occasionally compiled their balance sheets and income statements were 2.7 times more likely to be recipients of bank financing than those that did not (7.2% versus 2.7%).

Higher bank financing access was also seen in enterprises which prepared financial plans and cash flow forecasts.

### Bank accounts

MSMEs with a business bank account were nearly 13 times more likely to be recipients of bank financing.

<b>Business bank account and banks as a source of finance</b>	does have a business bank account	does not have a business bank account
Frequent source	5.8%	0.5%
Occasional source	20.5%	1.6%
Together	26.3%	2.1%



A similar, even if not as strong, relationship is found between holding ordinary accounts and bank financing. Those with accounts in private banks had 5 times higher probability of accessing bank

financing than those that did not. Those with accounts in government banks had 6.5 times higher probability of accessing bank financing than those that did not.

### **Type of customer**

Companies stating that their primary customer was the government or a State Owned Enterprise reported a higher rate of access to bank financing than those with other types of customers.

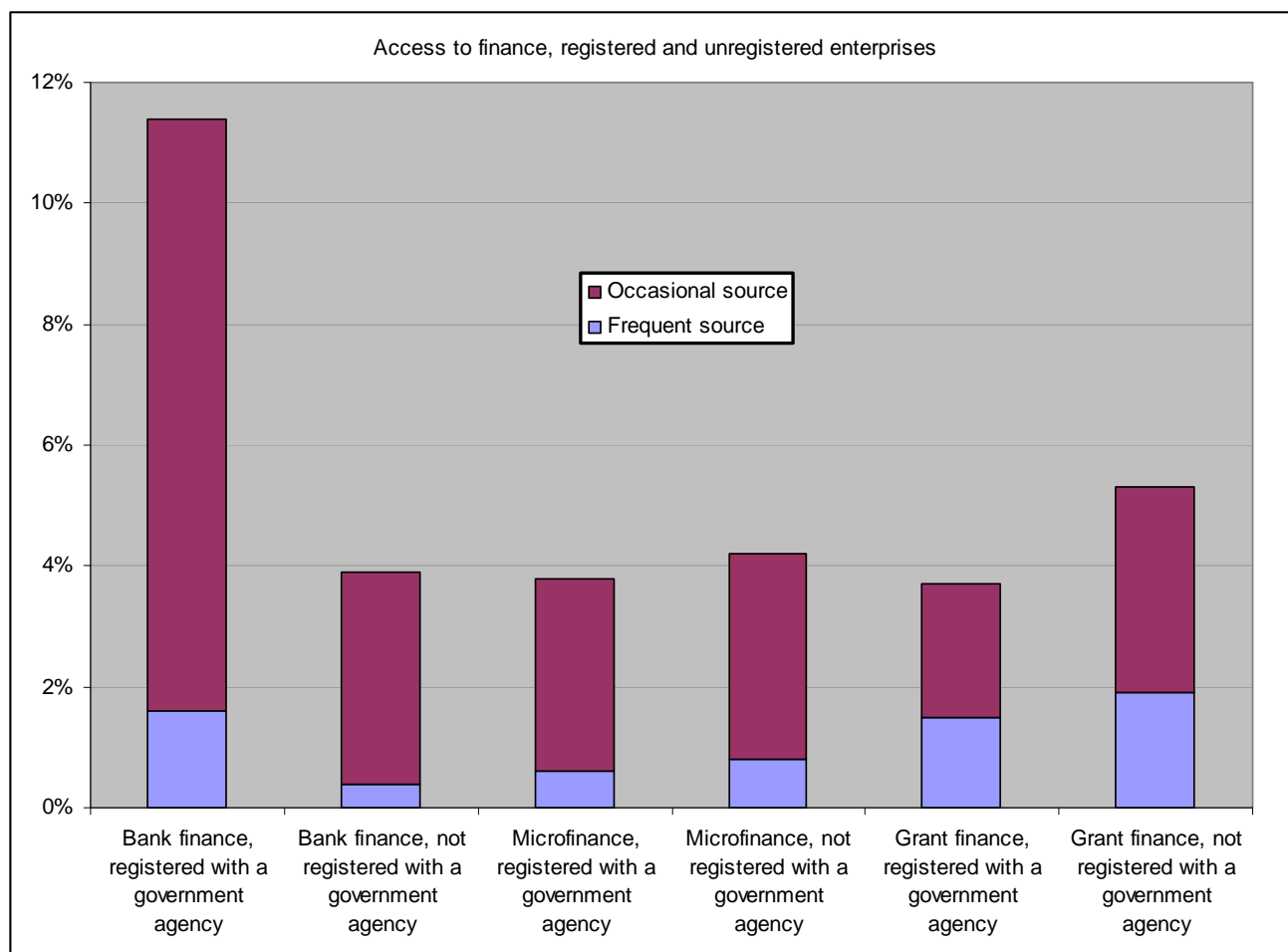
### **Technology**

Higher rates of access to bank financing were seen among companies that employed in their operations modern communication technologies, particularly with those that employed the technologies for marketing. Thus among the 17% of companies that employed stand-alone computers, the rate of access was 2.45 times higher than among those that did not. Among the 3.8% of companies that used internet advertising, the rate of access to financing was 2.29 times higher than among those that did not.

### **Formal versus informal sector.**

Being formally registered greatly enhances the probability of that MSME has access to bank finance. The probability that an enterprise registered with the government would have received bank financing was 4.26 times higher compared with unregistered enterprises (for 'frequent source of financing'). For bank financing as an occasional source of funding, the probability that an enterprise which is registered with the government has bank financing was 2.84 times higher.

Formal enterprises were also more likely to receive financing through a new partner or from money lenders. In contrast, companies that were not registered with government agencies had a higher rate of financing from grants and a somewhat higher rate of financing from microfinance institutions.



No significant differences between formal and informal sectors were found with respect to accessing other sources of finance.

### Membership in associations

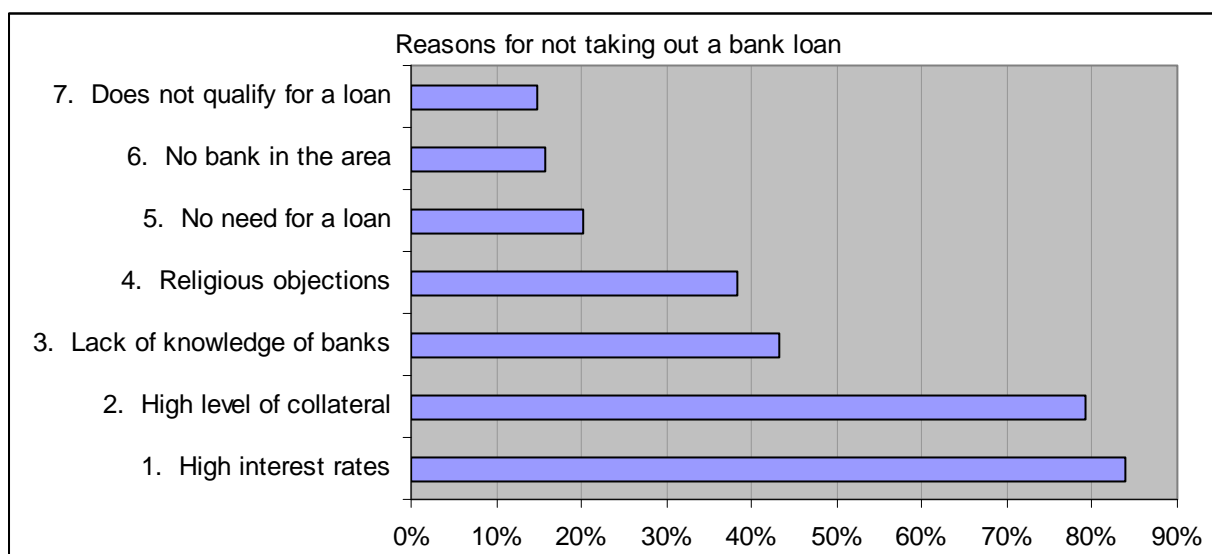
Enterprises which belong to a business association were 4 times more likely to be recipients of bank financing (12.9% versus 3.2%). With respect to professional association, the disparity was not so marked (7.6% versus 4.5%).

### Length of time in business

MSMEs were in the main new entities. Eighteen percent had been operating for two years or less and nearly 52% had been operating for five years or less. The results do not bear out the expectation that access to bank finance would be higher among enterprises that have a longer track record.

Length of time in business and banks as a source of finance	up to five years (51.7%)	6 years to 10 years (23.3%)	11 to 15 years (10.3%)	16 to 20 years (6.8%)	over 20 years (7.9%)
Frequent source	1%	1.2%	1.7%	2.3%	2.7%
Occasional source	4.2%	3.8%	2.6%	2.8%	6.4%
Together	5.2%	5.2%	4.2%	5.1%	9.1%

## 1.11 MSMEs WITHOUT BANK FINANCING - REASONS

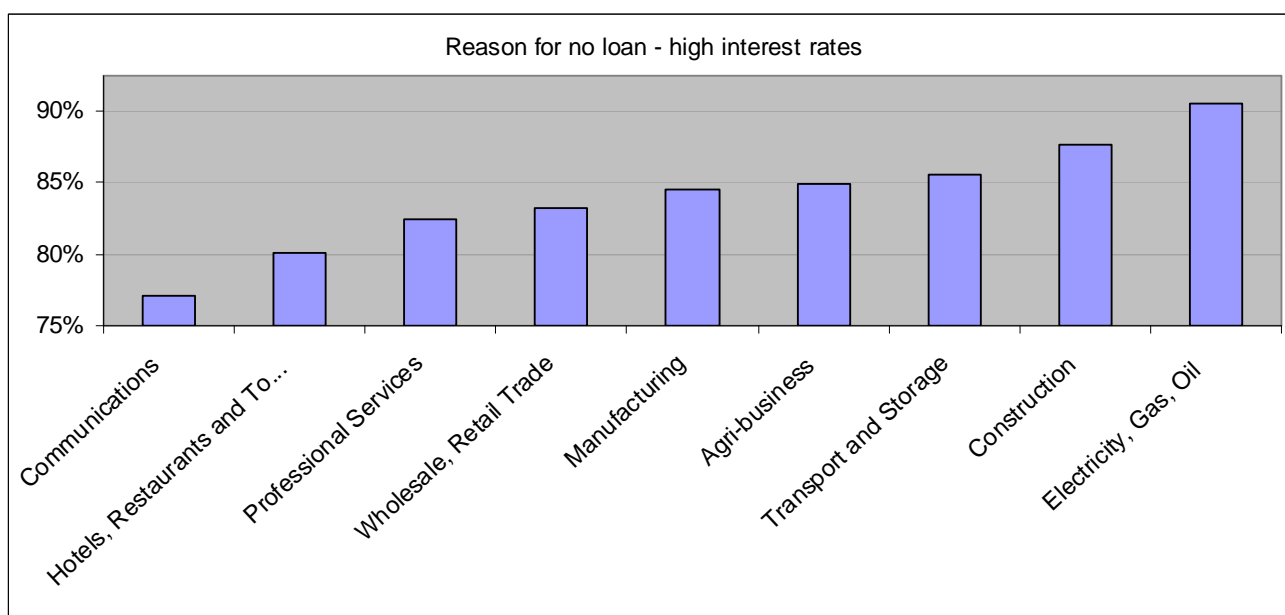


### High interest rates

A subset of 3750 respondents from the provinces of Basra, Wasit, Diyala, Mosul, Karbala, Qadisiya and Muthanna who did not have bank loans had been asked about their reasons why.

The most frequent reason for why no loans were taken was the high level of interest rates, an issue for 83.8% of MSME owners. The results were very similar for different industry sectors and ranged from 80.1% in the hospitality industry to 87.7% in the construction sector.

The outliers were the two smallest industry sectors in the sample - high interest rates were cited by 90.5% of MSMEs in the energy sector and by 77% of MSMEs in the communications sector.



Looking at different provinces, the order was:

1. Muthanna	-	71.6%
2. Diyala	-	74.1%
3. Mosul	-	78.1%
4. Basra	-	86.7%
5. Wasit	-	89.6%
6. Karbala	-	92%
7. Qadisiya	-	94.5%

It needs to be noted that, in these provinces, there is an overlap in the group of MSMEs which reject loans on grounds of high interest rates while at the same time stating that they would like to receive long-term financing or project financing from banks.<sup>17</sup> The respondents may have been under an impression that no interest rates would be charged for these products or else that, if charged, that they will be appreciably lower than interest rates charged for ordinary loans. This is corroborated by the fact that those MSMEs which stated that the interest rates were too high were more interested in banks providing long term financing than the others (88% versus 62%). Similarly, for project financing, 43% among those who thought interest rates were too high wanted banks to provide project financing versus 24% among the remainder.

The resistance to high interest rates does not vary much with older versus newer MSMEs, nor with whether they are profitable or not, nor with whether their economic situation is improving or not, nor with their size measured by employees or assets.

There are three explanations for these results.

Firstly, the previous GOI lending schemes at very low or even zero interest rates have created an unreasonable benchmark in the minds of businessmen.

Secondly, with the other ways of sourcing finance, the cost of funding is not made explicit (supplier or customer financing), or cannot be calculated (co-funding based bank finance), which makes the banks' interest rates appear unattractive by contrast.

Finally, resistance to high interest rates could be 'declarative'; a response possibly intended to influence the interest rates offered, as demonstrated in the analysis below.

A supplementary question was asked: "How much interest are you willing to pay on long term financing?"

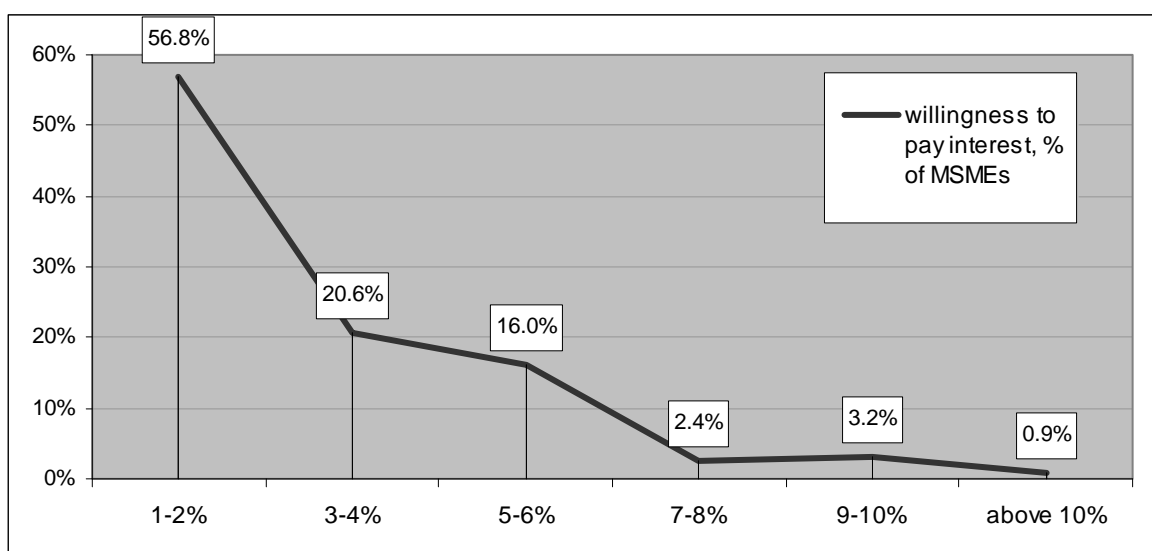
Willing to pay interest rate of ....	%
Not willing to pay any interest	26.3%
1% - 2%	41.9%
3% - 4%	15.2%

<sup>17</sup> For example, in Basra 520 out of 600 MSMEs stated that they did not have loans on account of high interest rates but 490 MSMEs from this group (94.4%) listed long-term financing as one of the additional services they would like the banks to provide. The average overlap for the seven provinces listed above is 86%, ranging from 57% for Muthanna to 97.4% for Qadisiya. Similar, although not as striking, overlap applies to answers provided on start-up financing and project financing.

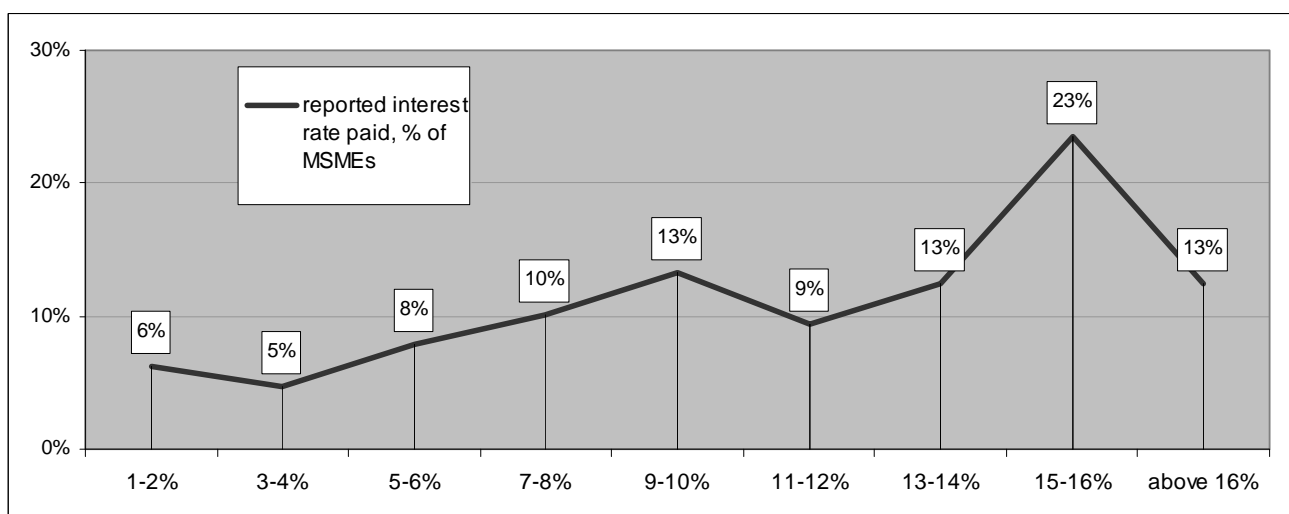
5% - 6%	11.8%
7% - 8%	1.8%
9% - 10%	2.4%
More than 10%	0.7%

Answers to this question, limited to respondents from the provinces of Basra, Wasit, Diyala, Mosul, Karbala, Qadisiya and Muthanna, need to be taken with a grain of salt as can be seen when comparing the profile of desired interest rates with interest rates actually paid by the respondents. The table below looks at the distribution of desired interest rates higher than zero (2601 cases).

Desired interest rates, 2601 cases:



Contrast this with the structure of interest rates actually paid (128 cases):



The most frequent interest rate is 15% and the proportion of businessmen paying interest rate above 10% is 58%.

Looking at the group of 21 businessmen who reported paying this rate, we see that none of them has reported that he would be willing to pay above 10%, 1 reported that he would be willing to pay in the interest rate range of 9-10%, 4 reported that they would be willing to pay in the interest rate range of 7-8%, 7 reported that they would be willing to pay in the interest rate range of 5-6%, 2 reported that they would be willing to pay in the interest rate range of 4-5% and 7 reported that they would be willing to pay in the interest rate range of 1-2%.

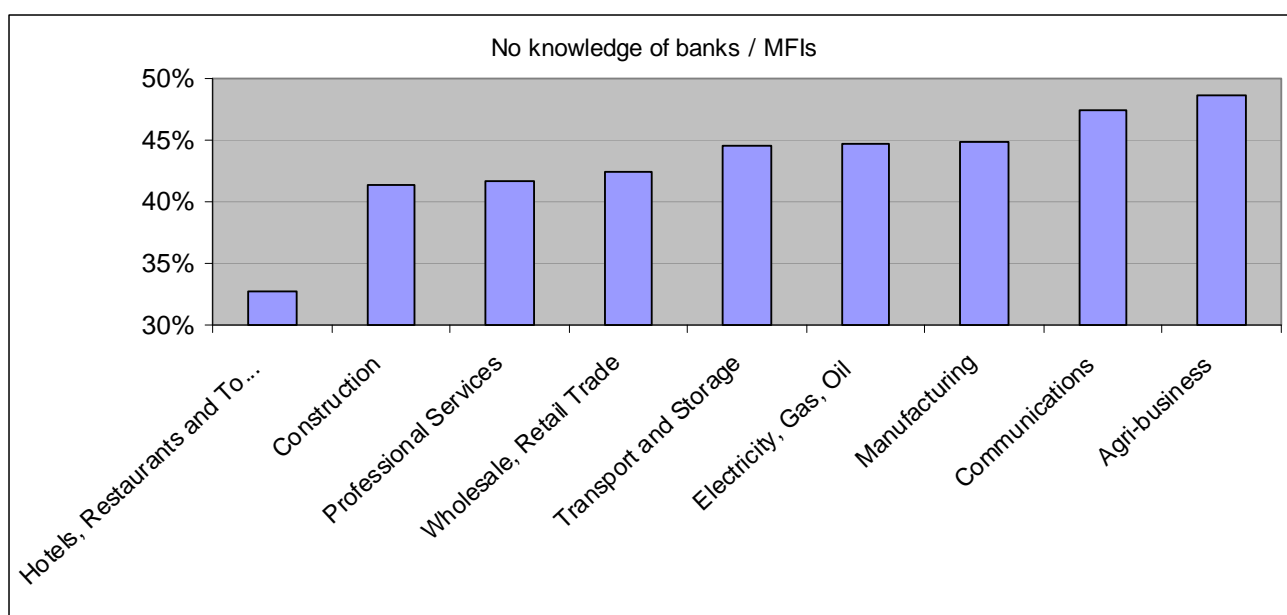
In other words, declared unwillingness to pay interest rates above 10% appears to be a negotiating statement and does not correspond to actual behavior. The readiness to pay is higher than the declared willingness to pay.

### High level of collateral

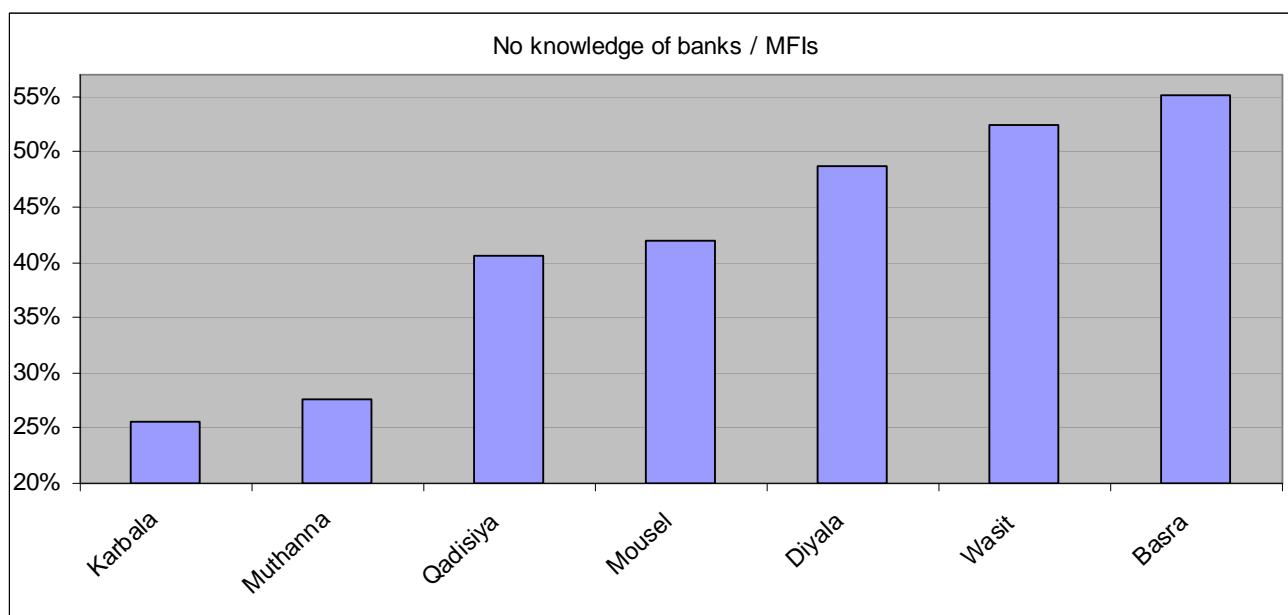
The **second** most frequently mentioned reason was **the high level of collateral** required. As answers to this question were also given in section 'Financial Constraints' which follows, and the pattern of answers was almost identical, it does not need an extensive description here.

### Lack of knowledge of financial institutions

The **third** most frequently mentioned reason was **the lack of knowledge of banks and MFIs**. Differences between industries were not large, ranging from 48.7% in agriculture to 32.7% in the hospitality sector.



The differences between provinces were larger, ranging from 55.1% in Basra to 25.6% in Karbala.



Other than being in the informal sector and being small (measured by assets), there were no other discernible correlations with this factor.

### Religious objections

The **fourth** most frequently mentioned reason was **objection to loans on religious grounds**.

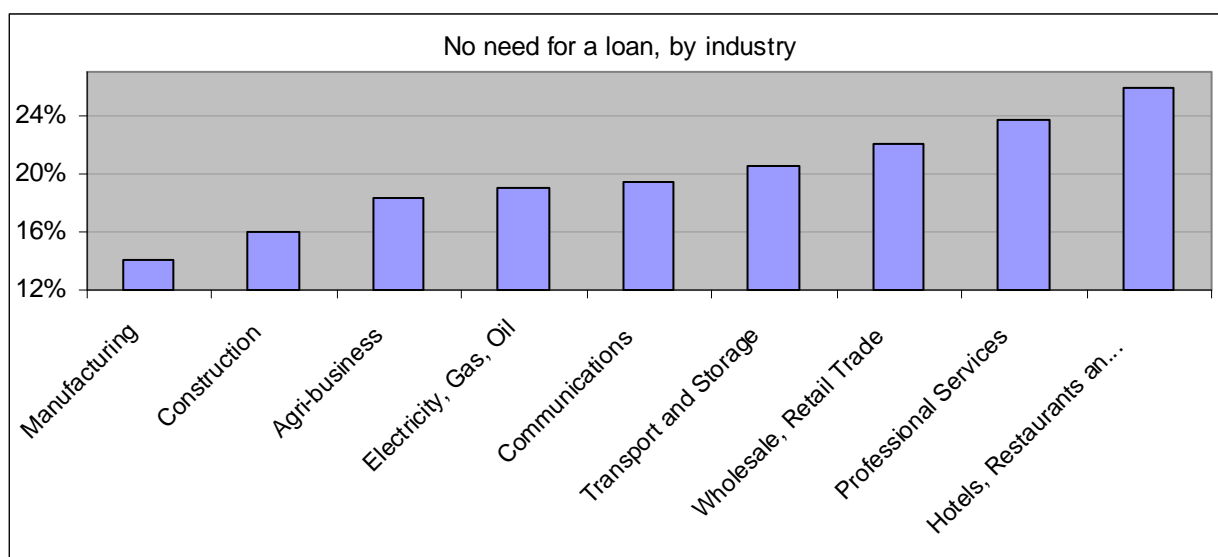
Religious reasons	
Mosul	73.9%
Diyala	64.6%
Basra	32.8%
Wasit	27.7%
Karbala	18.3%
Muthanna	14.8%
Qadisiya	11.1%

In industries, the range was much narrower, ranging from 30.5% in the energy sector to 43.2% in communications.

Religious objections diminished for the larger businesses (by assets or employees), but there was no discernible relationship with the age of the businessman or his level of education.

### No need for a loan

The **fifth** most frequently mentioned reason was that there was **no need for a loan**. This reason was most frequently cited by hospitality industry (25.9%), least frequently by manufacturers (14.1%).



Provincially, the answers ranged from 28% in Muthanna, down to 12% in Basra.

#### No financial institution in the area

The **sixth** most frequently mentioned reason was that there was **no financial institution in the area**.

Lack of financial institutions in the area	
Basra	28.5%
Karbala	19.4%
Mosul	19.1%
Diyala	13.8%
Wasit	8.1%
Muthanna	5.9%
Qadisiya	3.8%

As can be seen from the provincial tables, the least banked region is Basra.

Looking at industries, hospitality industry MSMEs mentioned inaccessibility of branches least often (11.3%) while the agricultural sector, as could be expected, comes at the top (21.8%).

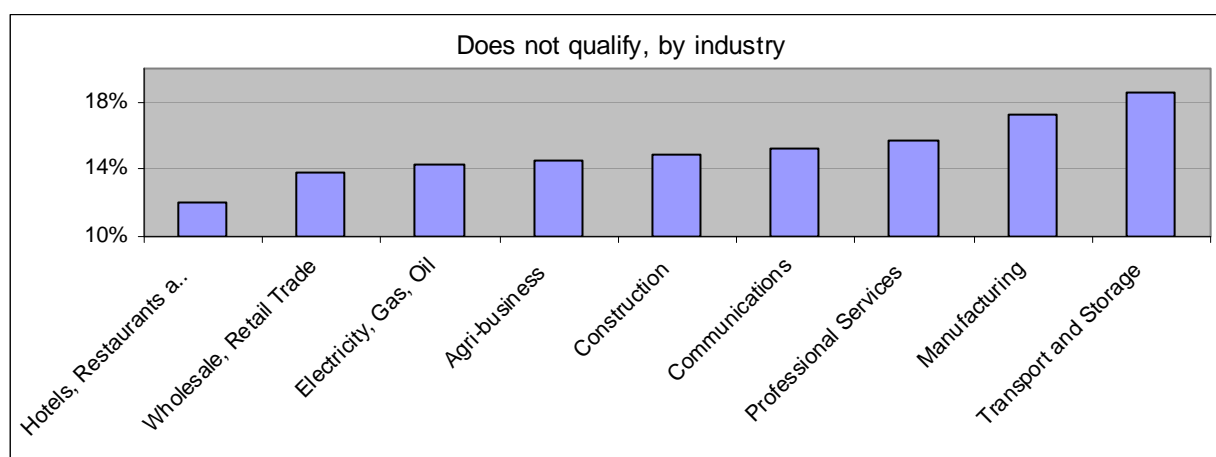
The sparsity of banking network has been documented in the 2007 Iraq Household Socio-Economic Survey (IHSES) which shows that 25.4% of Iraqis have more than 10 kilometers to their nearest bank branch.<sup>18</sup>

<sup>18</sup> Calculated from IHSES 2007, Table 2-00.

### The enterprise does not qualify for a loan

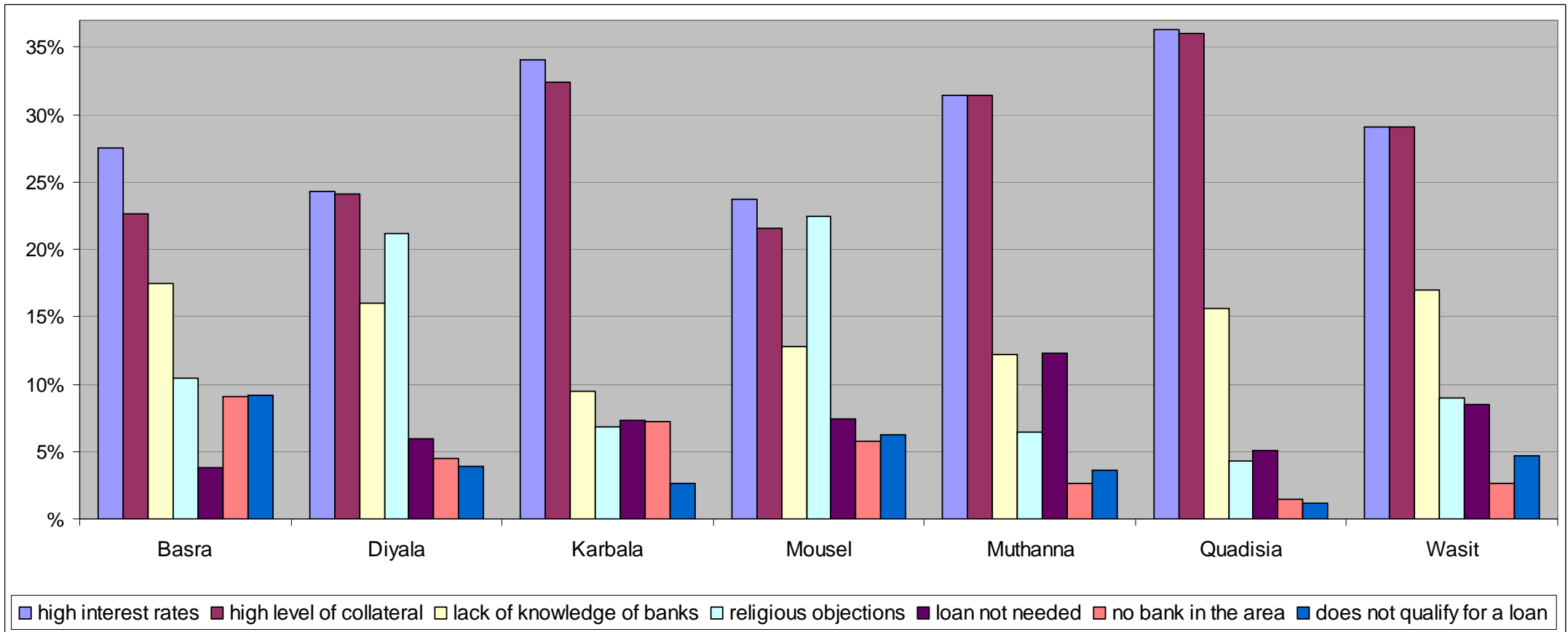
The **seventh** most frequently mentioned reason was that **the enterprise did not qualify for a loan**. This reason was most commonly given in the transport and storage industry and least commonly in the hospitality industry. Of note is the high percentage in Basra, a province that is more underfinanced than the others. Whether it is a case of excessive diffidence or a realistic assessment of their prospects with the financial institutions is an open question.

Does not qualify for a loan, by province	
Basra	28.8%
Mosul	20.5%
Wasit	14.5%
Diyala	12.5%
Muthanna	8.1%
Karbala	7.1%
Qadisiya	3.1%



**Summary results by province**

The table below shows the relative importance of the seven factors in each province (the responses for each province have been summed up to 100%).

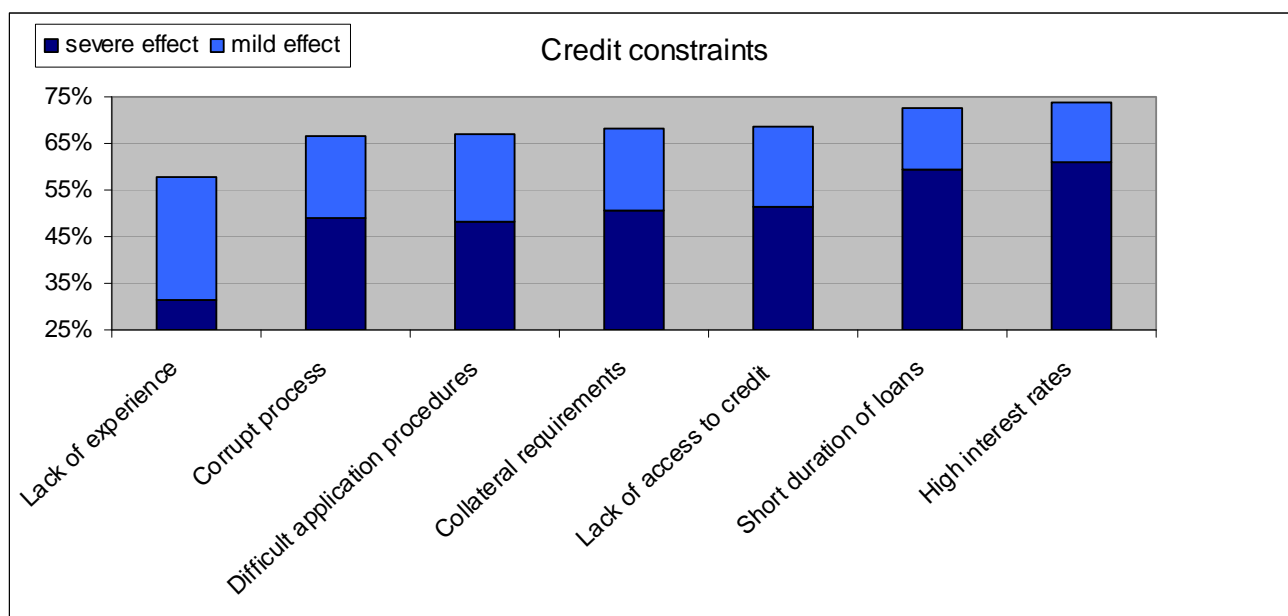


## 1.12 MSME FINANCIAL CONSTRAINTS

### Ranking

A question touching on interest rates was also included in a block of issues dealing with Financial Constraints that was presented to respondents in all provinces.

Respondents could rank a number of credit constraints as being of 'mild effect', 'severe effect', 'no effect' and 'not applicable'.<sup>19</sup> The highest percentage was scored by high interest rates, closely followed by short duration of loans.



MSME financial constraints (11450 cases)	High interest rates	Short duration of loans	Lack of access to credit	Collateral requirements	Difficult application procedures	Corrupt process	Lack of experience
Severe effect	60.9%	59.4%	51.5%	50.5%	48.1%	49.1%	31.3%
Mild effect	12.9%	13.3%	17.3%	17.9%	18.8%	17.5%	26.3%
No effect	10.0%	10.5%	13.8%	13.3%	14.5%	13.3%	21.5%
Not applicable	16.1%	16.9%	17.4%	18.4%	18.6%	20.1%	20.9%

These results are very similar for both the respondents with external financing and those that do not have it.

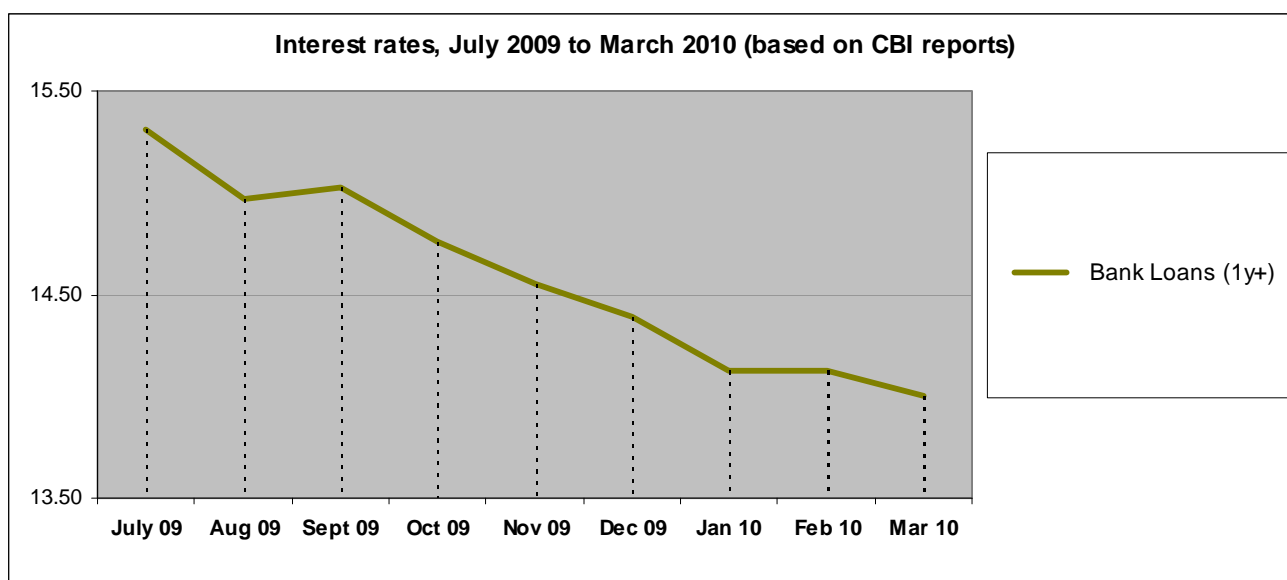
<sup>19</sup> These were listed in the following order: 1. lack of access to credit, 2. stringent collateral requirements, 3. lack of experience with credit institutions, 4. difficult application procedures, 5. high interest rates, 6. short tenure of loans, 7. corrupt system for obtaining loans.

## High interest rates

What interest rates were MSME owners and principals reacting to? The average interest rate paid cited by Market Assessment respondents was 11.76%<sup>20</sup>, below the rates for bank loans as published by CBI. The Table below shows the rate for bank loans of one year's duration or longer as published by CBI in its weekly Key Financial Indicators series.

It is clear that there is a resistance to the current level of commercial rates. In focus discussion groups, respondents expressed their preference for interests rates well below 10%, some explicitly mentioning 4%, others even 2%.<sup>21</sup> However, as the discussion in section 1.11 shows, there is an element of cognitive dissonance in responses to this question.

The Table below shows the evolution of bank lending rates over the period of time the surveys had been held. The first batch of surveys was held in August and September 2009, the second batch of surveys was held in from December 2009 to February 2010. Although the interest rates had gone down between the two survey batches, percentage of MSMEs claiming that high interest rates were a constraint on their operations was higher for the second group of provinces surveyed (84.2%) than for the first group of provinces surveyed (68.8%).



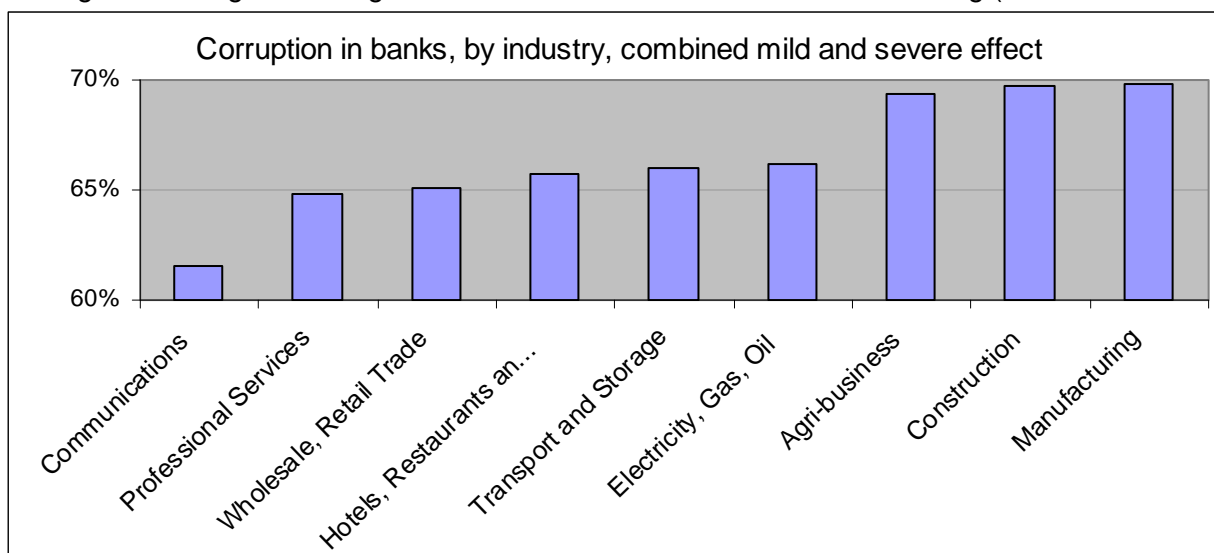
<sup>20</sup> Some of the loans were concessionary 4% loans from GOI entities but the poor quality of data in response to this question does not allow for a separate calculation of commercial and non-commercial rates.

<sup>21</sup> For example, Focus Discussion Group #13 in Basra (light manufacturing) came up with the following recommendation for GOI action: "Provide simple business loans with a 2% interest rate and long-term repayment."

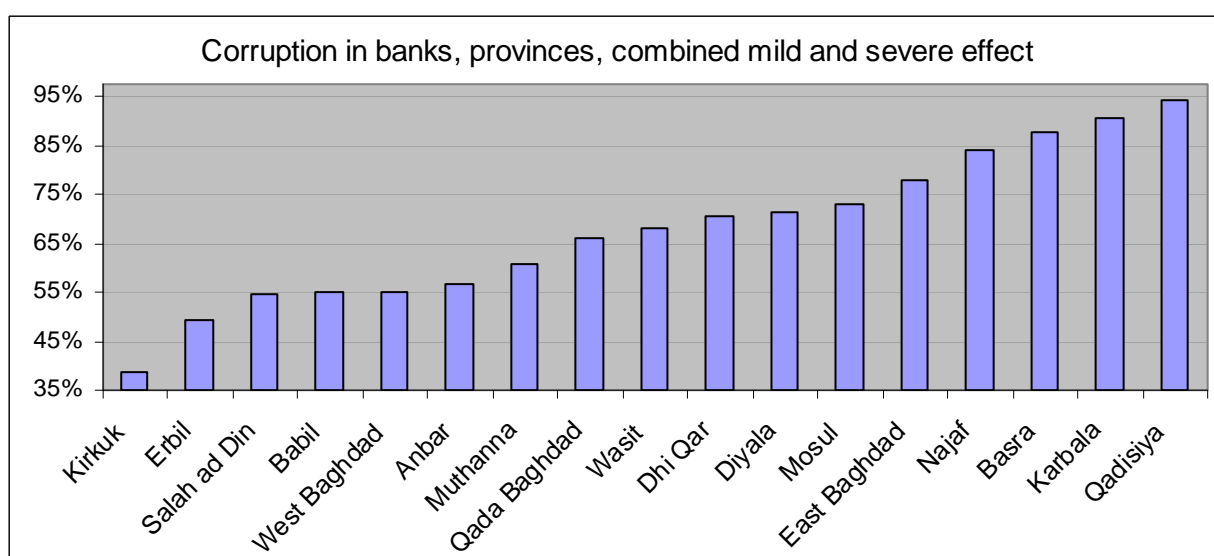
### Corruption

The corruption issue deserves a special mention because its effect is to increase the cost of the loan further. According to anecdotal evidence from focus group discussions, some bank loan officers reportedly demand illicit payments of up to 30% of the value of the loan.

17.5% of respondents have considered the effects of corruption to be 'mild', 49.1% as severe. The percentages were higher among those who have had access to bank financing (16.3% and 59.2%).<sup>22</sup>



Looking at provincial results, 21.3% of respondents in Erbil have classified this as having severe effect while the corresponding percentage in Qadisiya was 81.7%.



<sup>22</sup> The percentages among those who have had bank financing but no microfinancing were 15.5% and 63.7%. The percentages among those who have had microfinancing but no bank financing were 25.6% and 47.1%. This suggests that the problem is more severe in banks.

In the following table, provinces are sorted in the order in which 'severe effect' was reported.

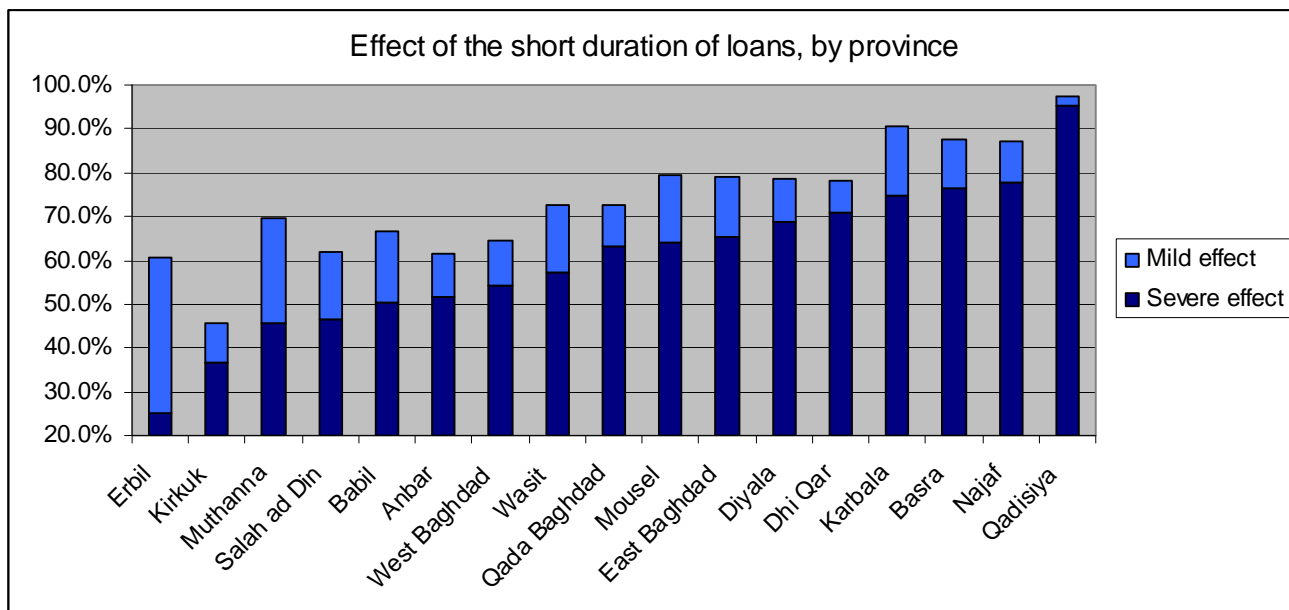
<b>Corruption</b>	Severe effect	Mild effect	No effect	Not applicable	% severe effect after excluding 'not applicable'
Erbil	21.3%	27.9%	31.2%	19.7%	26.5%
Kirkuk	26.1%	12.4%	19.5%	42.0%	45%
Muthanna	36.0%	24.7%	8.4%	30.9%	52.1%
Salah ad Din	37.7%	17.1%	12.6%	32.6%	55.9%
Babil	38.5%	16.6%	24.7%	20.2%	48.2%
West Baghdad	42.4%	12.8%	12.8%	32.1%	62.4%
Qada Baghdad	44.7%	21.2%	10.7%	23.4%	58.4%
Anbar	44.8%	11.9%	21.7%	21.6%	57.1%
Diyala	49.0%	22.4%	10.9%	17.6%	59.5%
Wasit	52.0%	16.0%	14.9%	17.1%	62.7%
Mosul	54.1%	18.9%	9.1%	17.8%	65.8%
Dhi Qar	55.4%	15.1%	6.7%	22.8%	71.8%
East Baghdad	58.8%	18.9%	6.7%	15.6%	69.7%
Najaf	63.3%	20.8%	12.8%	3.1%	65.3%
Basra	73.5%	14.0%	5.2%	7.3%	79.3%
Karbala	73.9%	16.6%	4.8%	4.8%	77.6%
Qadisiya	81.7%	12.7%	2.8%	2.8%	84.1%

While the responses did not distinguish between state banks and private banks, corruption would appear to be prevalent in both as can be inferred from the following result. Of businessmen who held accounts only with private banks, 14.4% stated that corrupt system for obtaining credit affected them mildly and 46.8% stated that it affected them severely. Of businessmen who held accounts only with government banks, 19.8% stated that corrupt system for obtaining credit affected them mildly, 47.5% stated that it affected them severely.

### **Short duration of loans**

The second most frequently cited financial constraint was the short duration of loans. Looking at 'mild' and severe' effect combined, this was of least concern in transport and storage (69.5%) and communications (69.9%) and of most concern for manufacturers (77.2%) and agribusiness (75.6%).

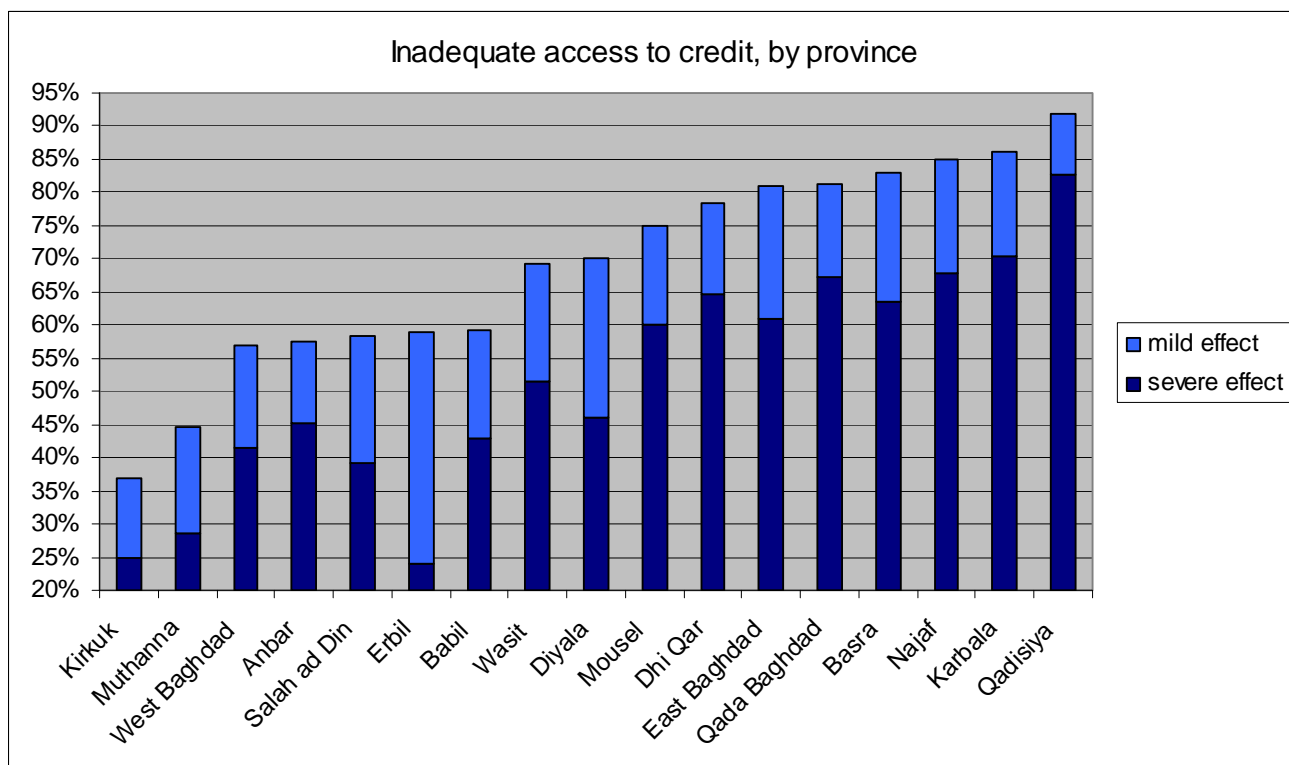
Results for provinces range from 45.7% in Kirkuk to 97.5% in Qadisiya.



The short duration of loans was of more concern for MSMEs with larger number of employees and to older businesses. Loan duration, as could be expected, was of far more concern to those MSMEs that plan to expand in the next 24 months (77.3%) than to those which do not (53%).

**Lack of access to credit**

The third most frequently cited financial constraint was the lack of access to credit. The differences between industries were not large. Manufacturing topped the list with 71.9% while the industry complaining of this least frequently was the energy sector with 65.9%. Regionally, the dispersion was wider:

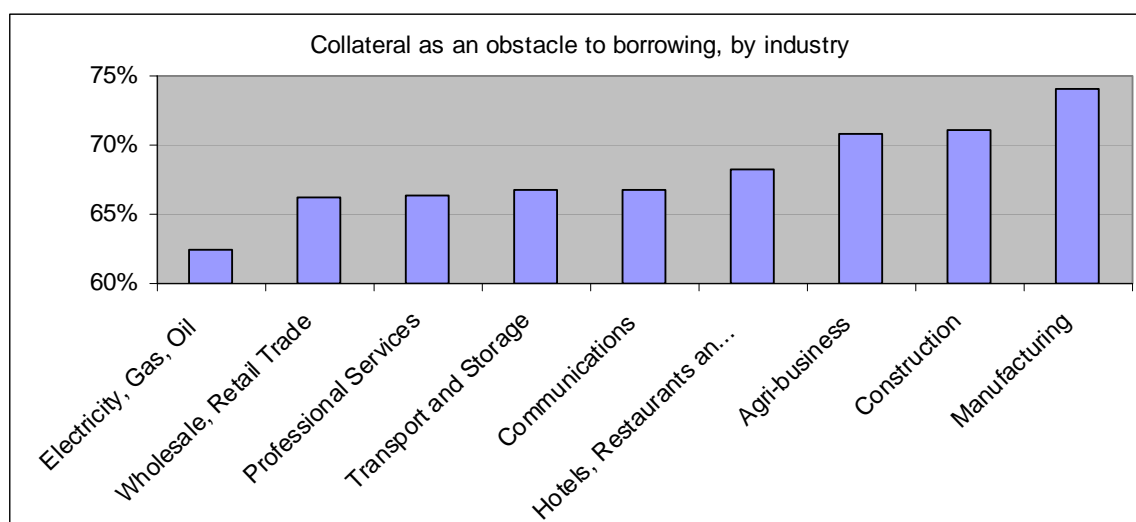


The top rank of Qadisiya is interesting as Qadisiya MSMEs enjoy the highest level of access to credit of all Iraqi provinces surveyed.<sup>23</sup>

### High collateral requirements

The fourth most frequently cited financial constraint were the collateral requirements. The sector complaining about this constraint most frequently was manufacturing, while it was mentioned least frequently by the energy industry.

Collateral requirements	
Manufacturing	74.1%
Construction	71.1%
Agribusiness	70.8%
Hospitality	68.2%
Communications	66.8%
Transport and storage	66.7%
Services	66.3%
Wholesale and retail	66.2%
Energy	62.4%



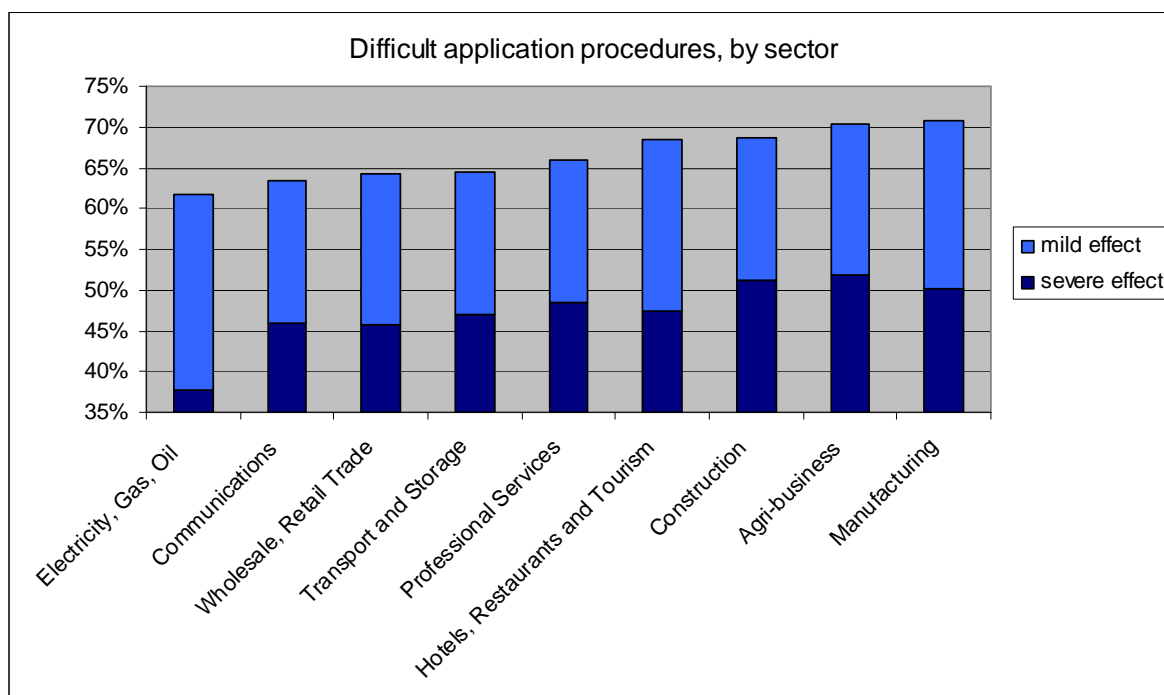
The differences between provinces were wider than differences between industries, ranging from 35.3% in Kirkuk to 92.3% in Qadisiya.

### Difficult application procedures

The fifth most frequently cited financial constraint was the difficulty of application procedures. The industry results were as follows:

<sup>23</sup>

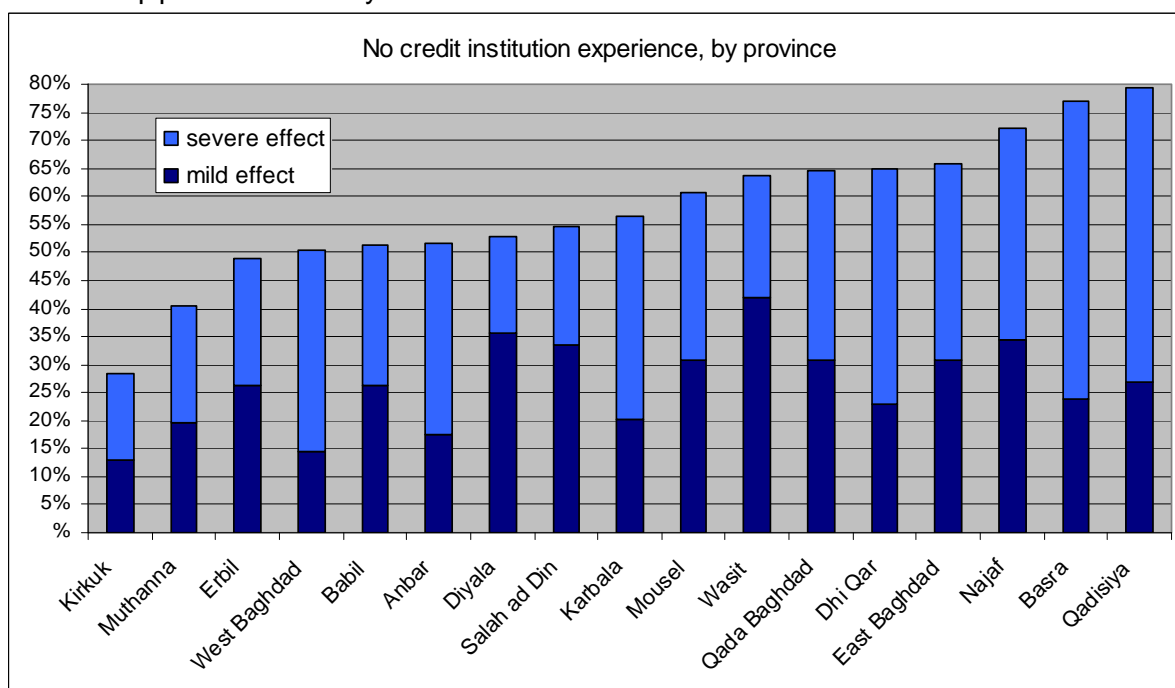
It is to be noted that the extent of reported deprivation does not always coincide with the situation in which MSMEs find themselves. Inadequate access to credit was complained of more often by MSME categories which reported greater access to finance (larger MSMEs, MSMEs with bank accounts) than by the remainder.



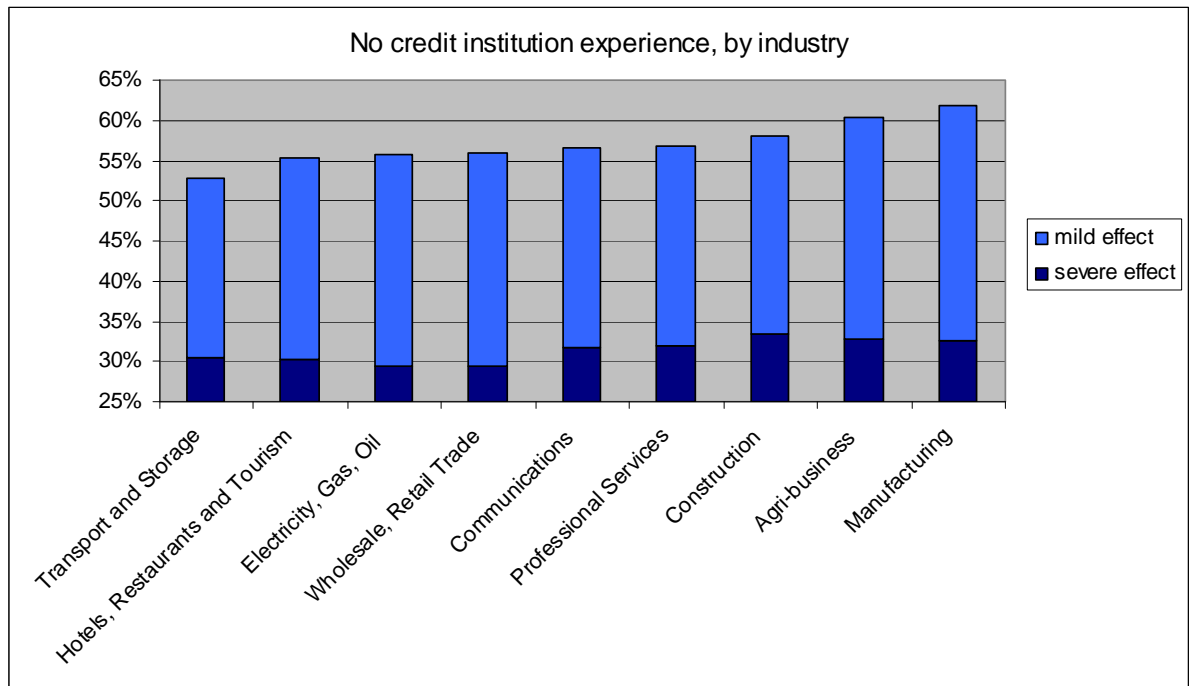
No correlation was found between this variable and the size of the firm or the educational level of its owner.

### Lack of experience with credit institutions

The sixth most frequently cited financial constraint was the lack of experience in obtaining credit. Again, the top rank of Qadisiya is interesting as Qadisiya MSMEs enjoy the highest level of access to credit of all Iraqi provinces surveyed.<sup>24</sup>



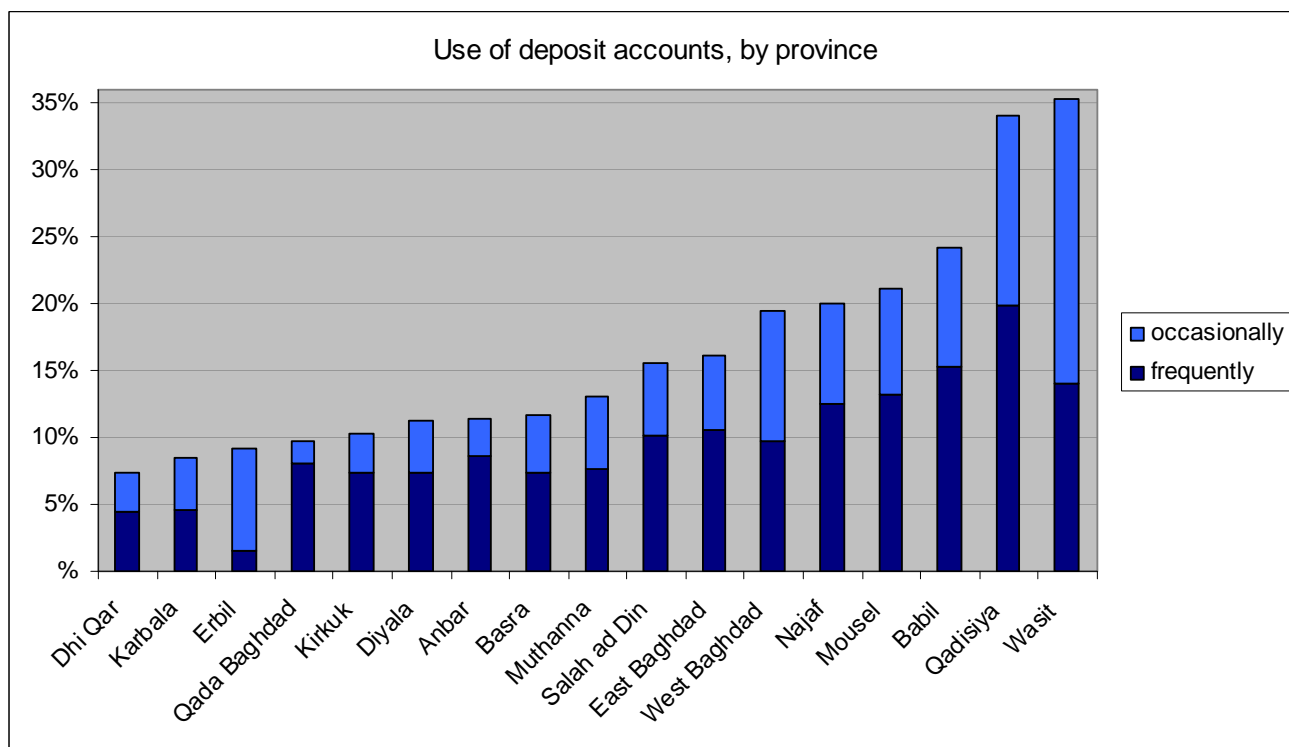
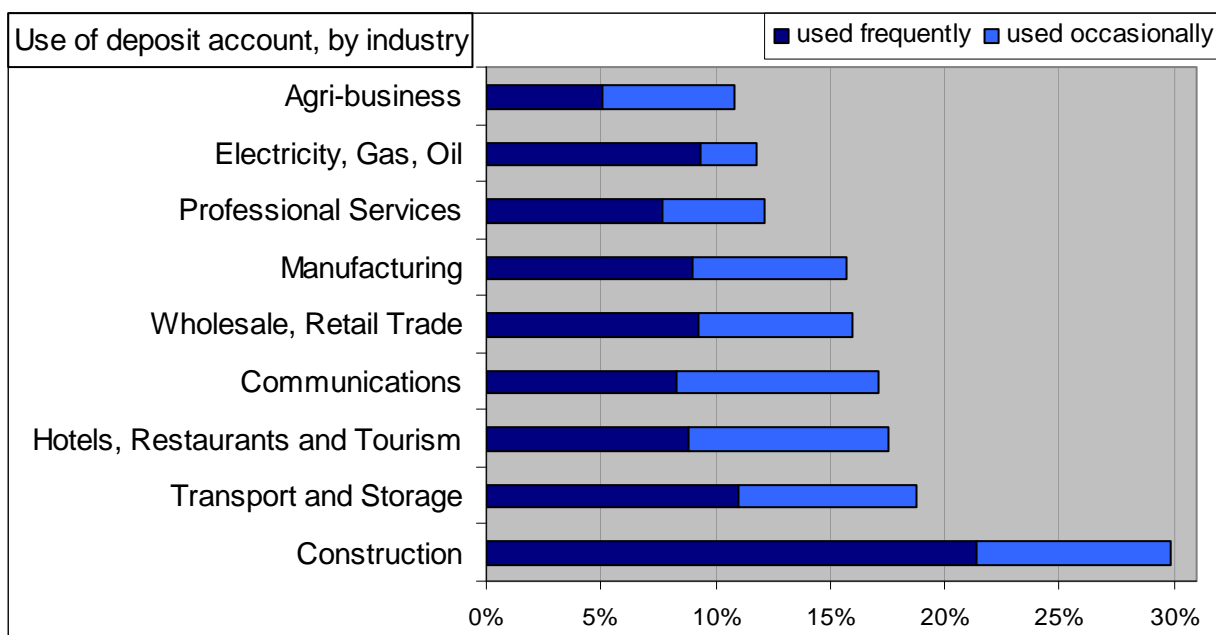
<sup>24</sup> Qadisiya results show a number of apparent inconsistencies, possibly due to the fact that the survey was not administered properly in that province.



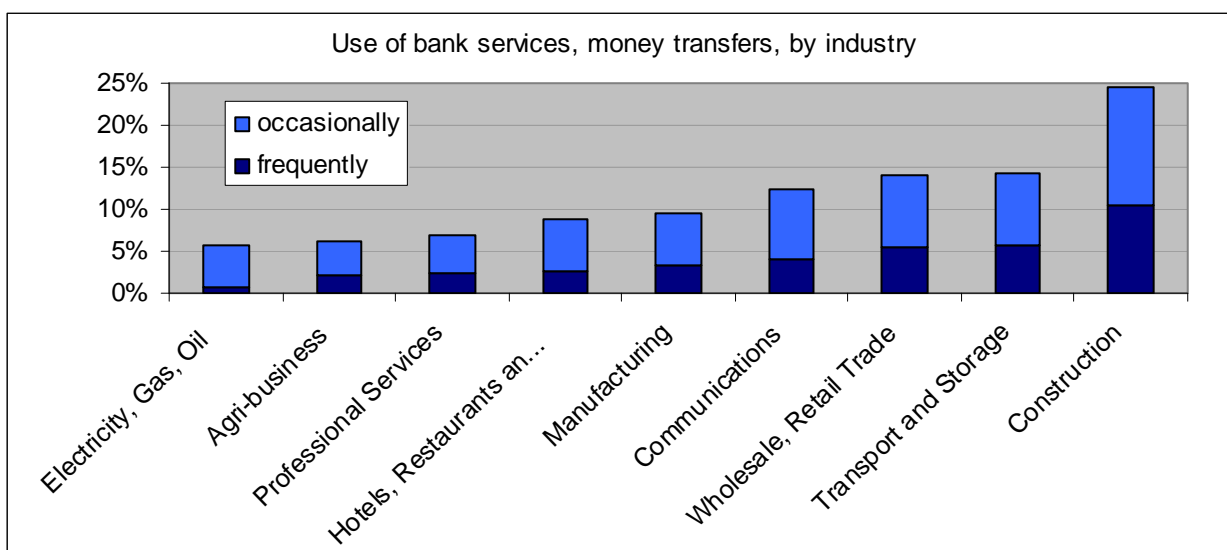
No correlation was found between this variable and the size of the firm or the educational level of its owner.

### 1.13 BANKING SERVICES CURRENTLY USED BY MSMES

#### Deposit accounts

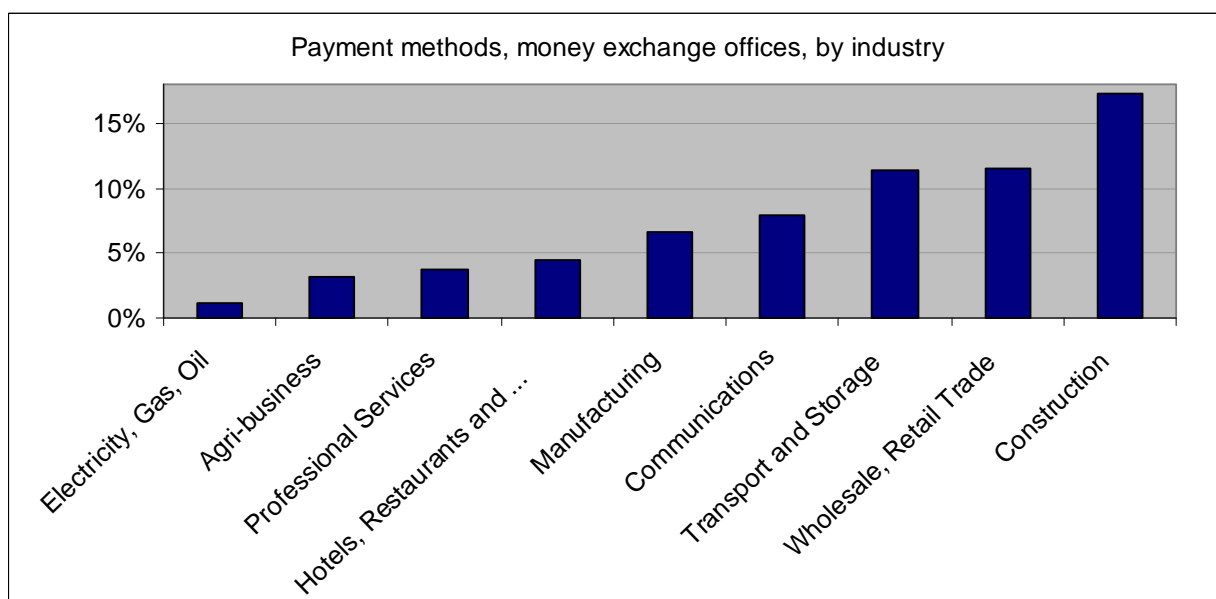


**Money transfers**



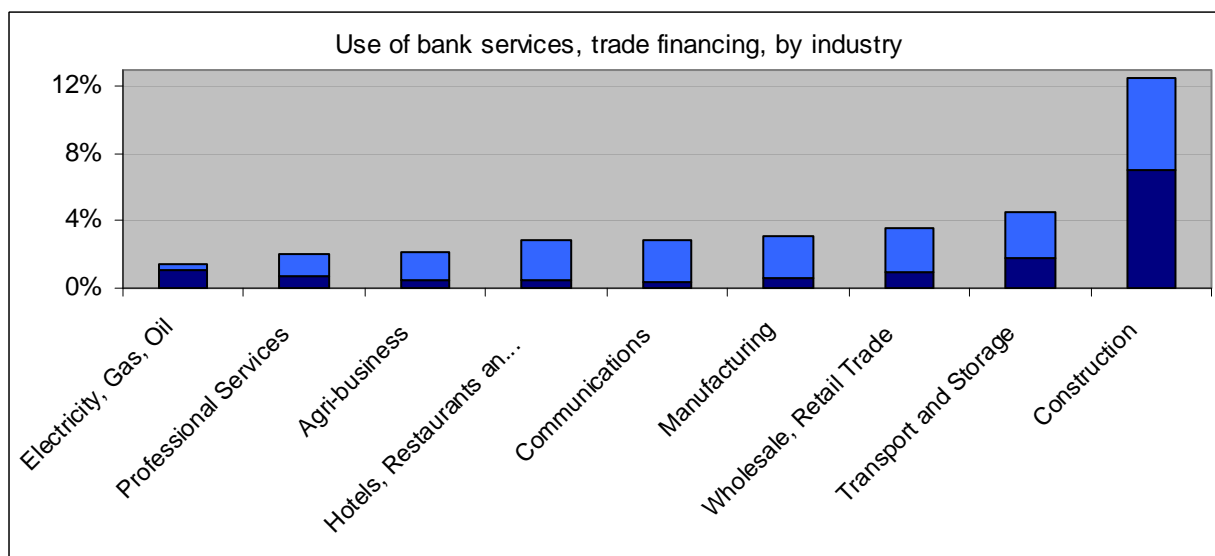
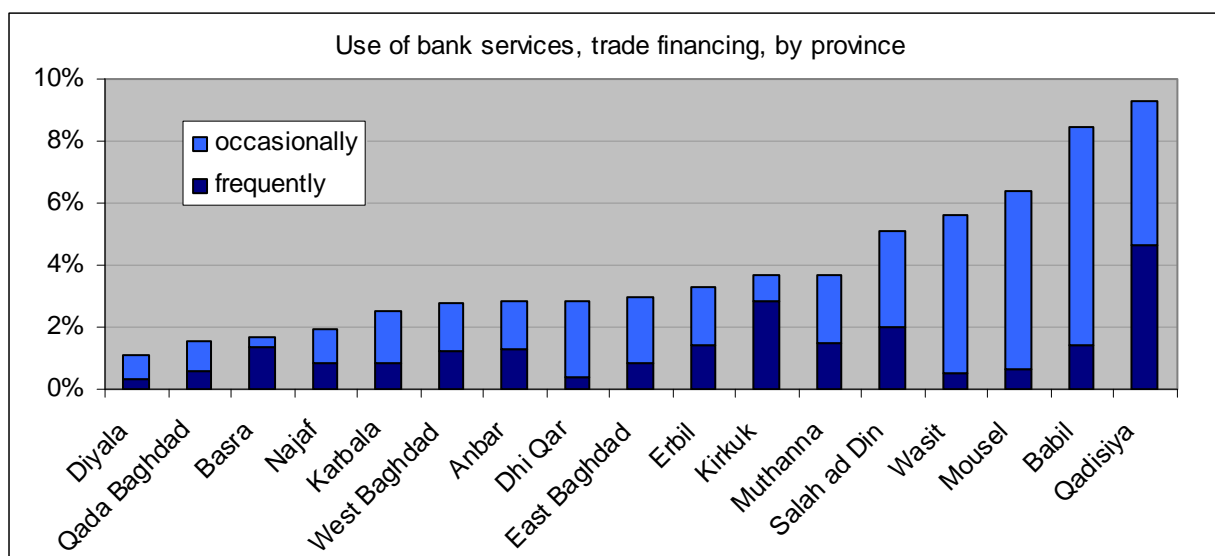
Overall, 4.2% of Iraqi MSMEs use banks to transfer money frequently and another 7.1% use banks for this purpose occasionally.

Money exchange offices are also frequently used for payments by MSMEs (overall, 7.8% use them).

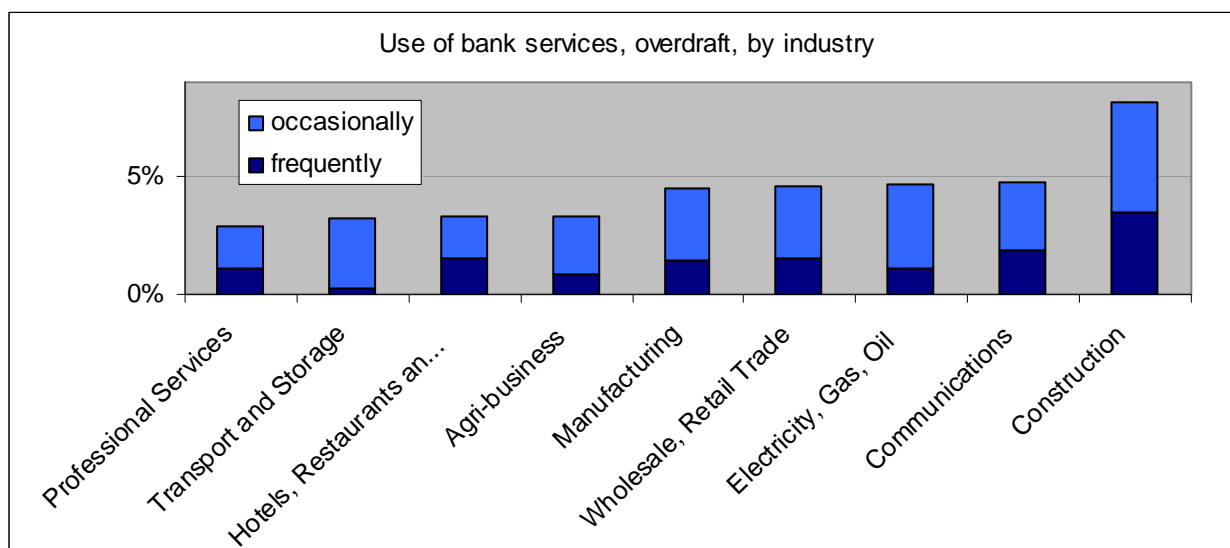


However, the dominant proportion of MSMEs (87.5%) makes payments in cash.

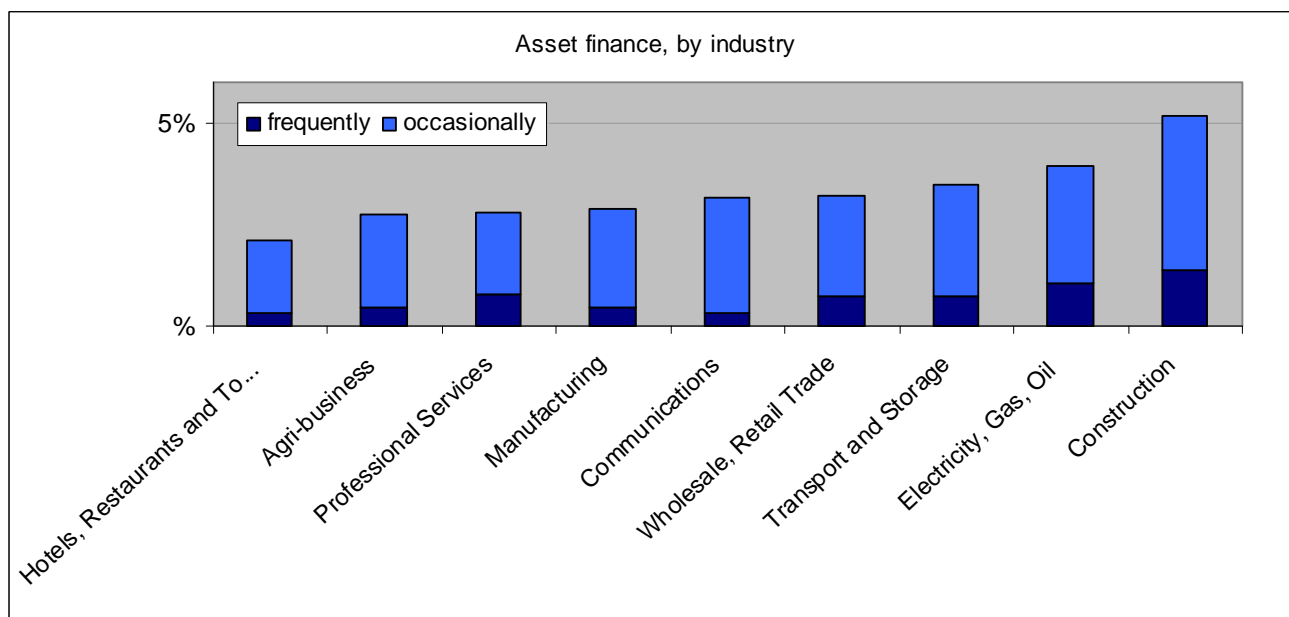
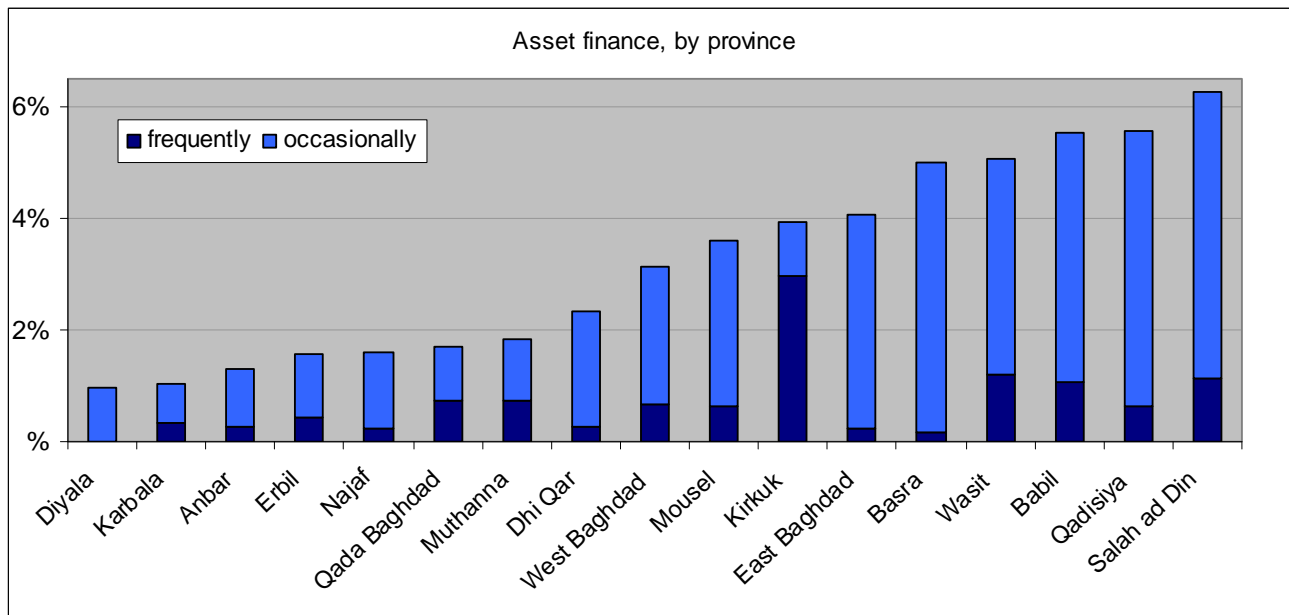
**Trade financing (e.g. letters of credit)**



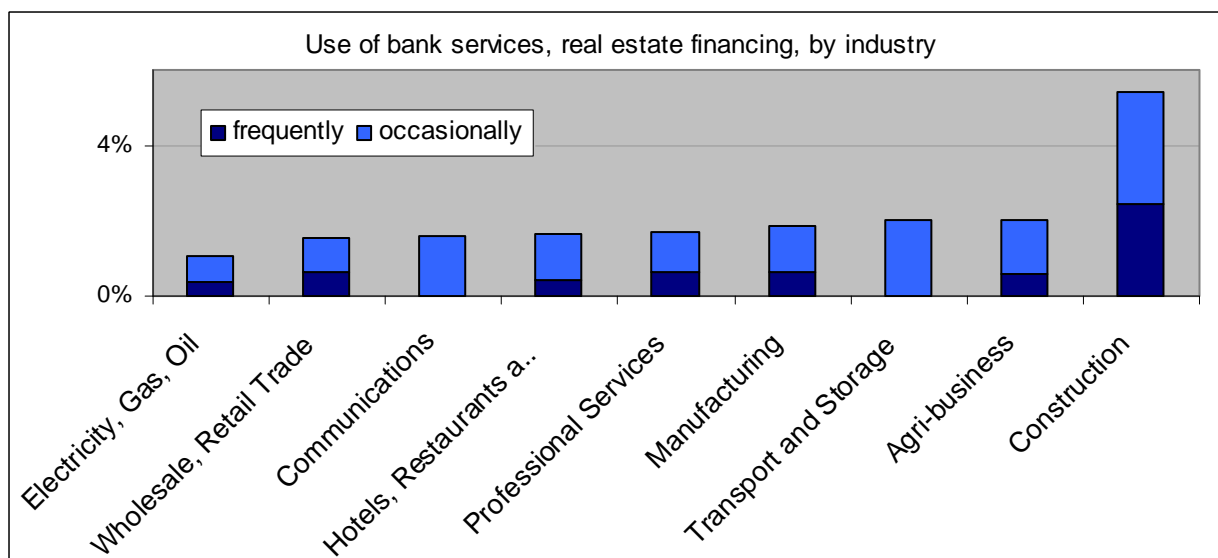
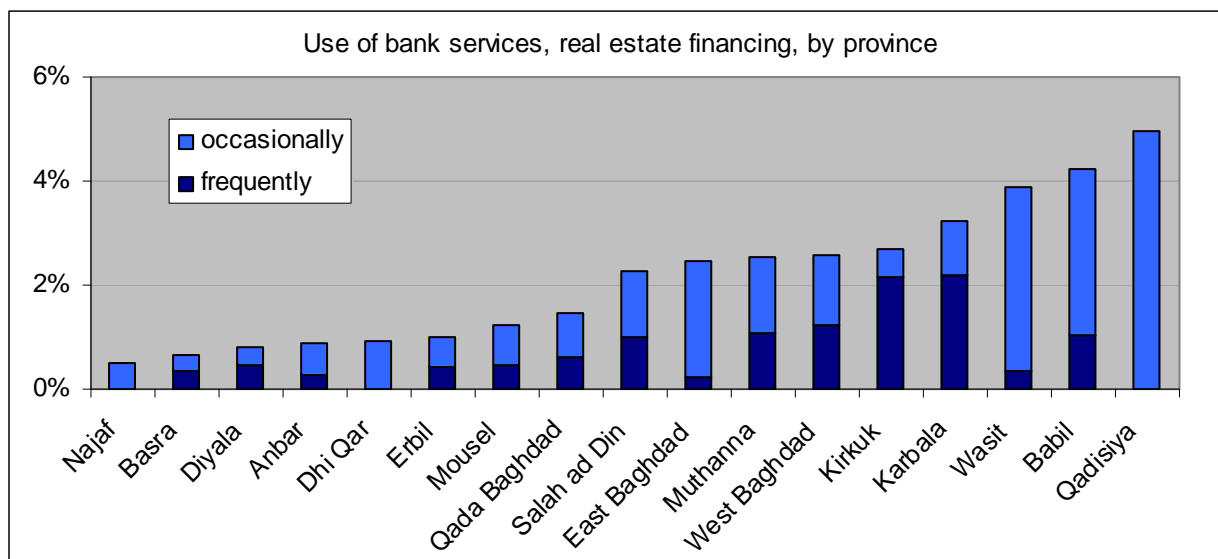
**Overdrafts**



**Asset Finance (e.g. leasing)**



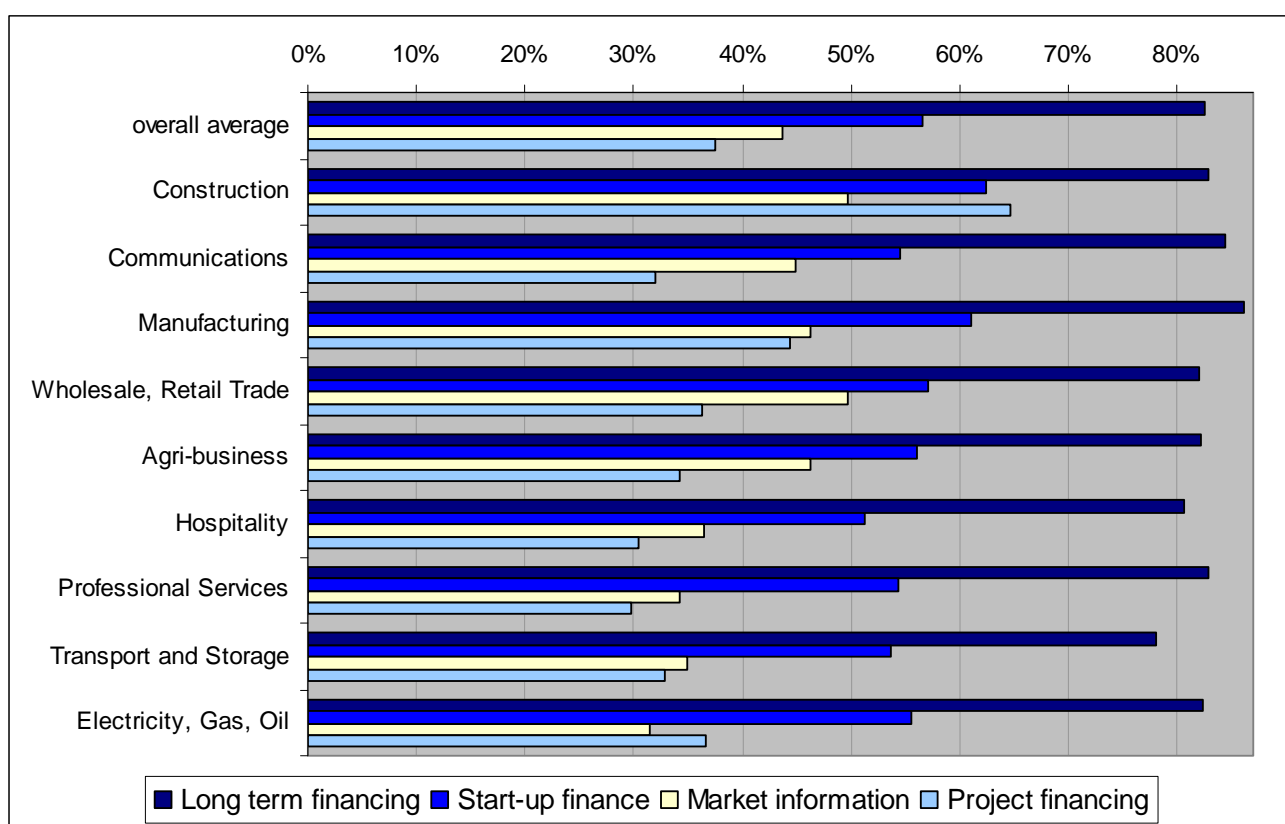
**Real Estate Finance**



## 1.14 SERVICES WHICH MSMES WOULD LIKE TO BE PROVIDED BY BANKS

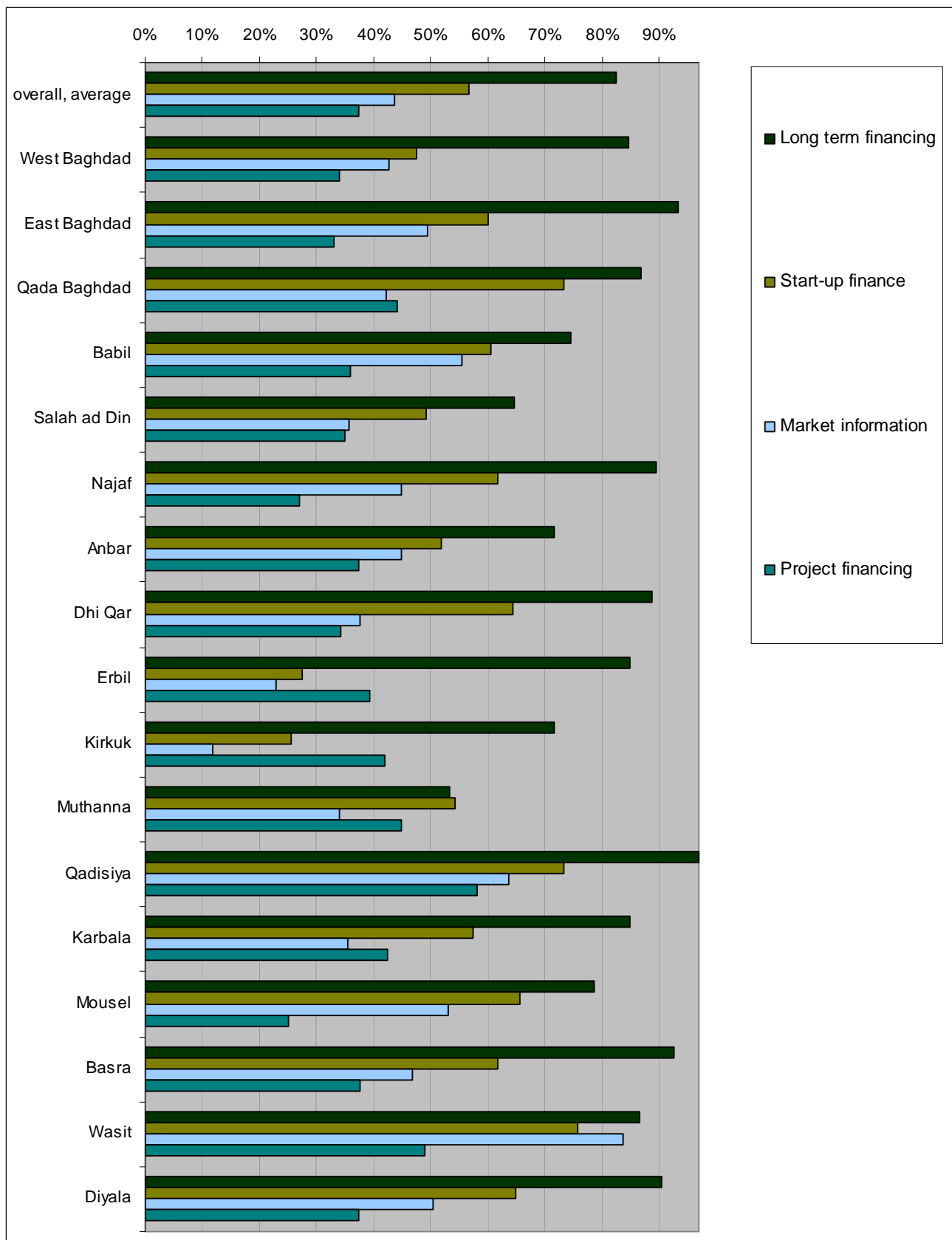
Respondents were asked which additional banking services they would like the banks to provide for them, given a number of options.<sup>25</sup> By far the most popular were additional modalities of loan financing – long-term financing, start-up financing and project financing. Of the remaining potential services that could be provided by banks, only the provision of market information elicited high level of interest.

Industry eliciting the highest level of interest in additional financing opportunities was construction while energy showed least interest.



Geographically, the level of interest in additional financing opportunities was highest in Wasit and Qadisiya, the lowest in Salah ad Din and Kirkuk.

<sup>25</sup> The options were presented in the following order (the number in brackets shows the importance given to the issue by respondents): Long tem financing (1); Business planning (5); Operations consulting (6); Forums for MSME – bank interaction (9); Start-up finance (2); Financial planning (8); Export development assistance (10); Market information (3); Project financing (4) and Financial literacy training (8).



## Long term financing

The variability of demand for long term financing at the level of industries was small. The lowest demand was expressed by transport and storage sector (78.1%), the highest demand expressed by manufacturing MSMEs (86.1%).

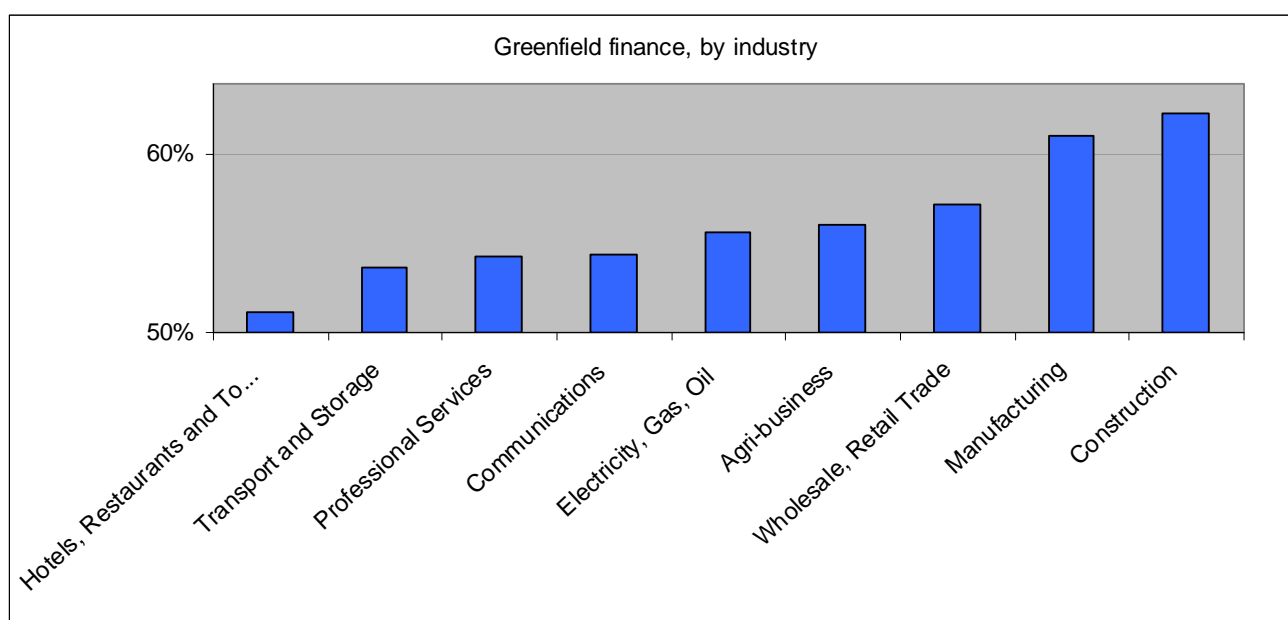
The variability of demand for long term financing at the level of provinces was large. The lowest demand was in Muthanna (53.3%), the highest in Qadisiya (96.9%). While a part of this variability between provinces can be explained by differences in industry composition and size of MSMEs in the sample, the rest can be accounted for by different preferences of businessmen in these provinces. These preferences will be dealt with in greater detail in the section outlining the reasons why businessmen do not want to take out bank loans.

Preference for long term financing was much more common (80.6%) among those who stated that they plan to make additional investments over the next 24 months than among those who had no such plans (7.9%).

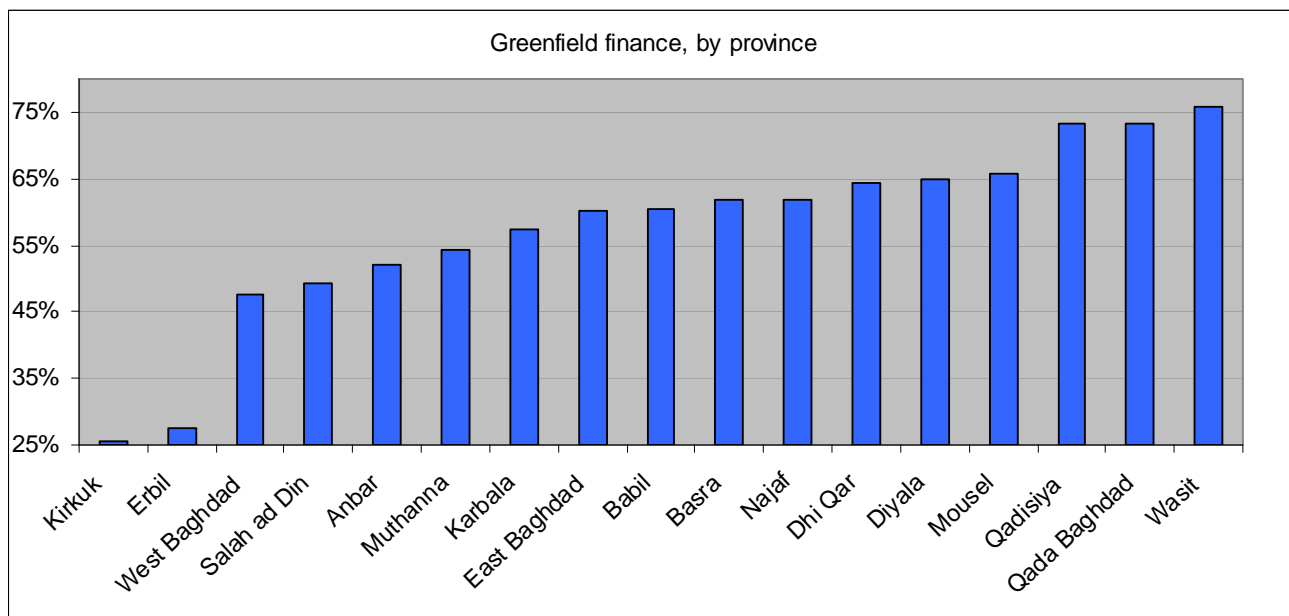
Note also that preference for long-term financing was expressed more frequently by those who have named banks as one of the sources of their finance and also more frequently by those with higher levels of current indebtedness. This suggests that the higher desire to use banks may reflect familiarity with the operations with banks rather than the level of financial need.

## Greenfield financing

The level of demand for start-up financing was lower and the variability of demand larger than for long-term financing. The largest demand was expressed by construction MSMEs (62.4%), which can be explained by the fact that in this industry each new order is treated as a separate new project; the lowest demand by hospitality sector (51.2%).

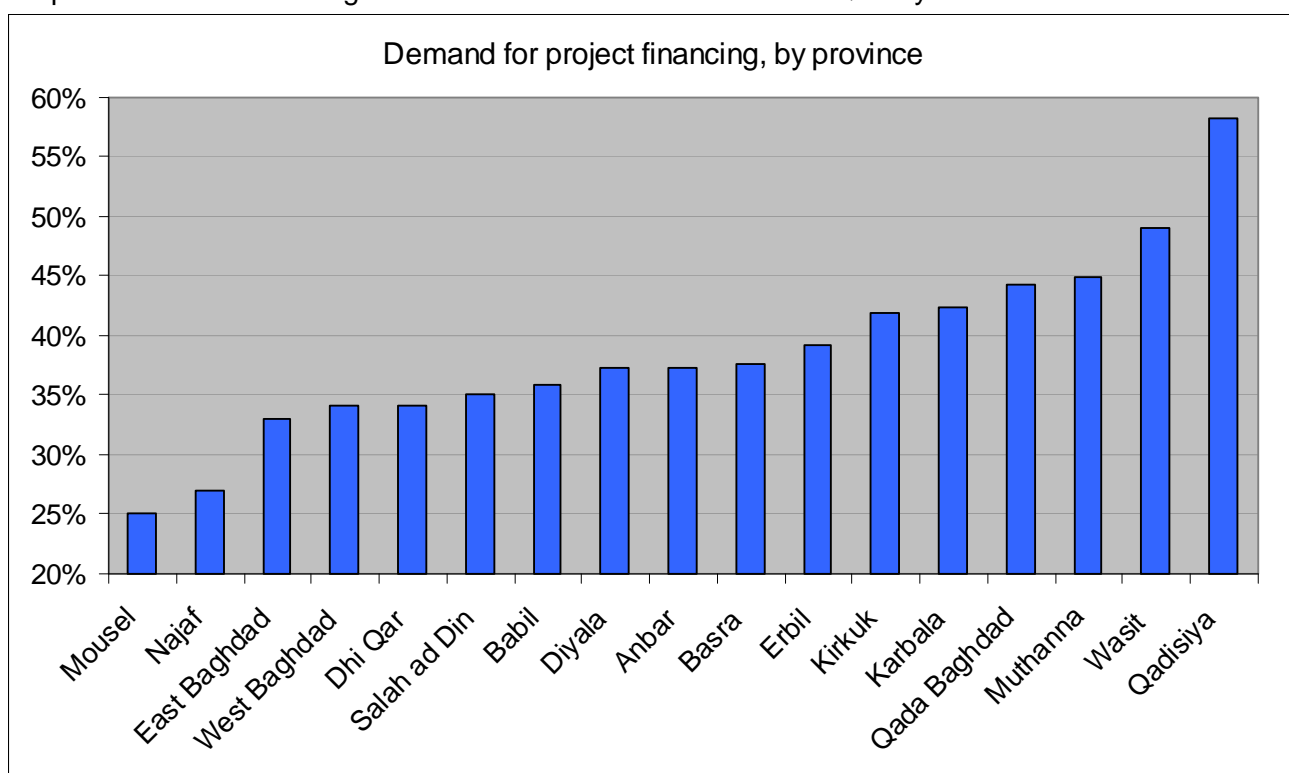


At the level of provinces, the largest demand was expressed in Wasit (75.7%), the lowest demand in Kirkuk (25.7%).

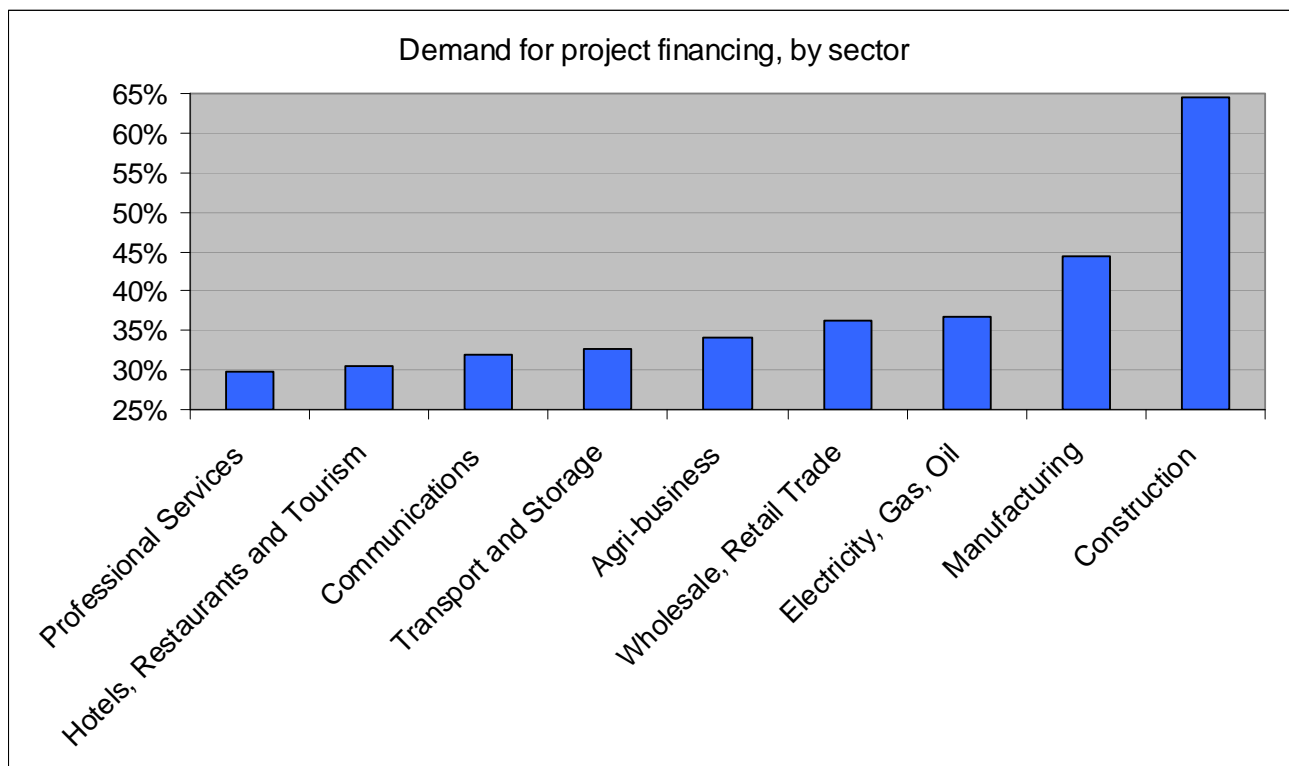


**Project financing**

Respondents' demand ranged from 25.1% in Mosul to 58.2% in Qadisiya.

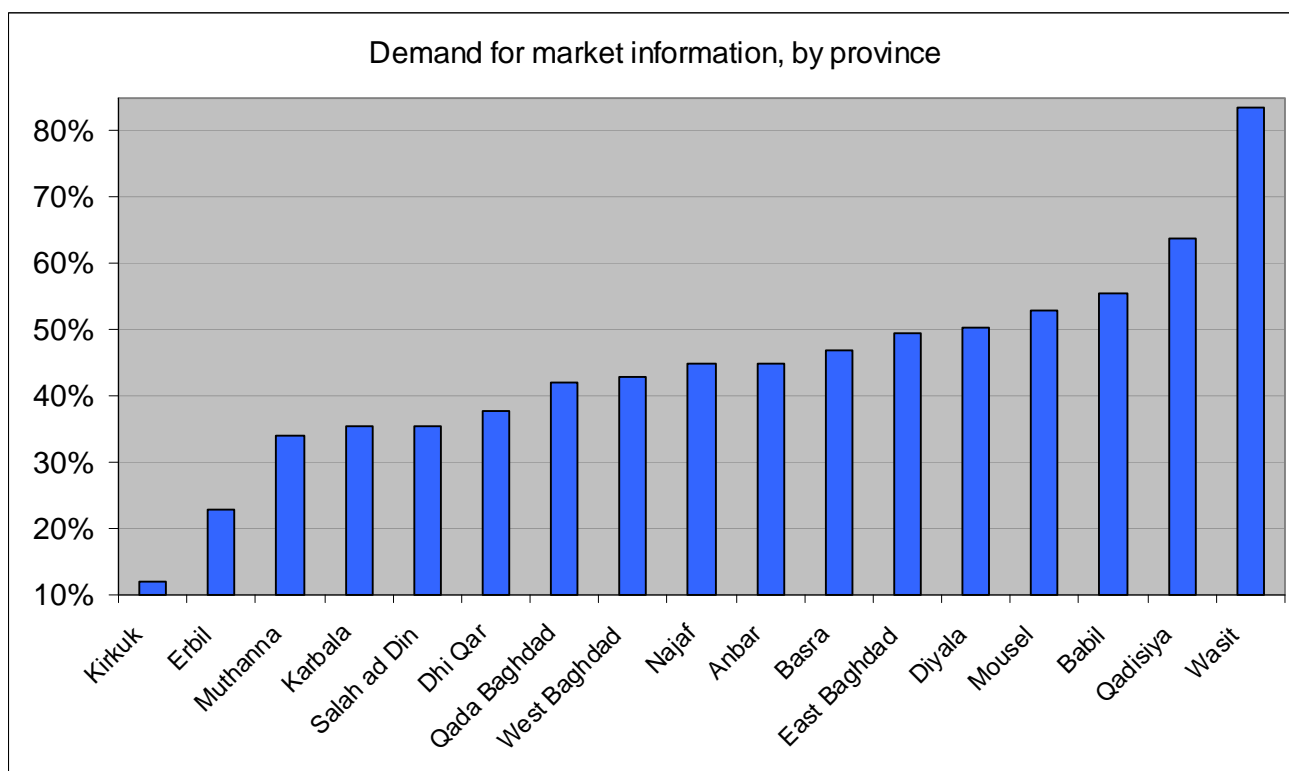


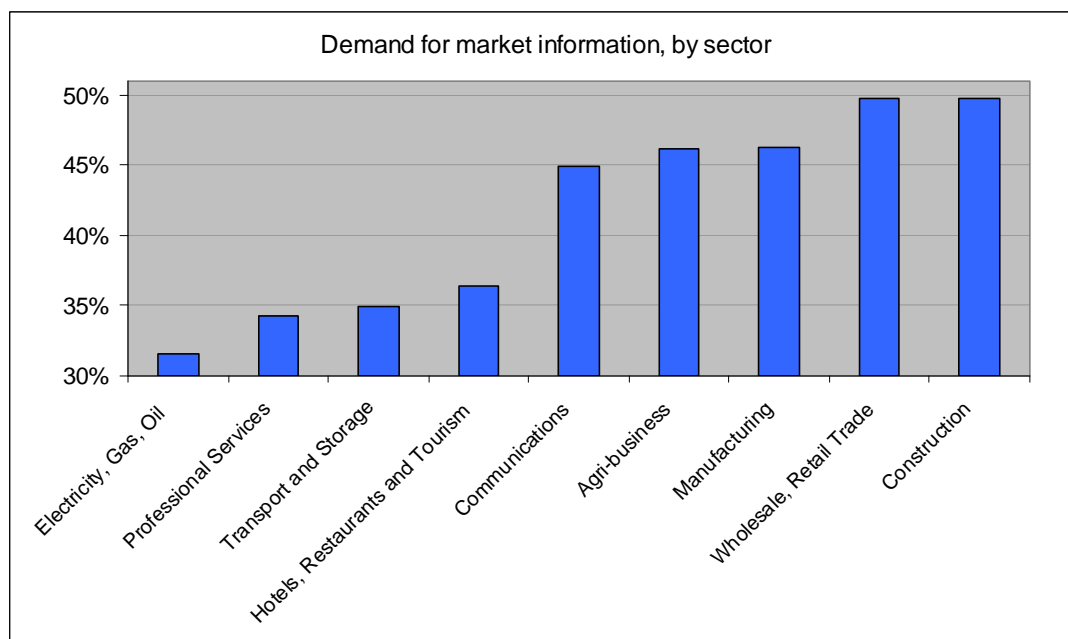
The variability among the sectors matched, for once, the variability among the provinces. The largest demand was expressed by construction MSMEs (64.6%); the lowest demand by professional services (29.7%).



### Market information

The most demanded non-financial bank service in demand was market information:

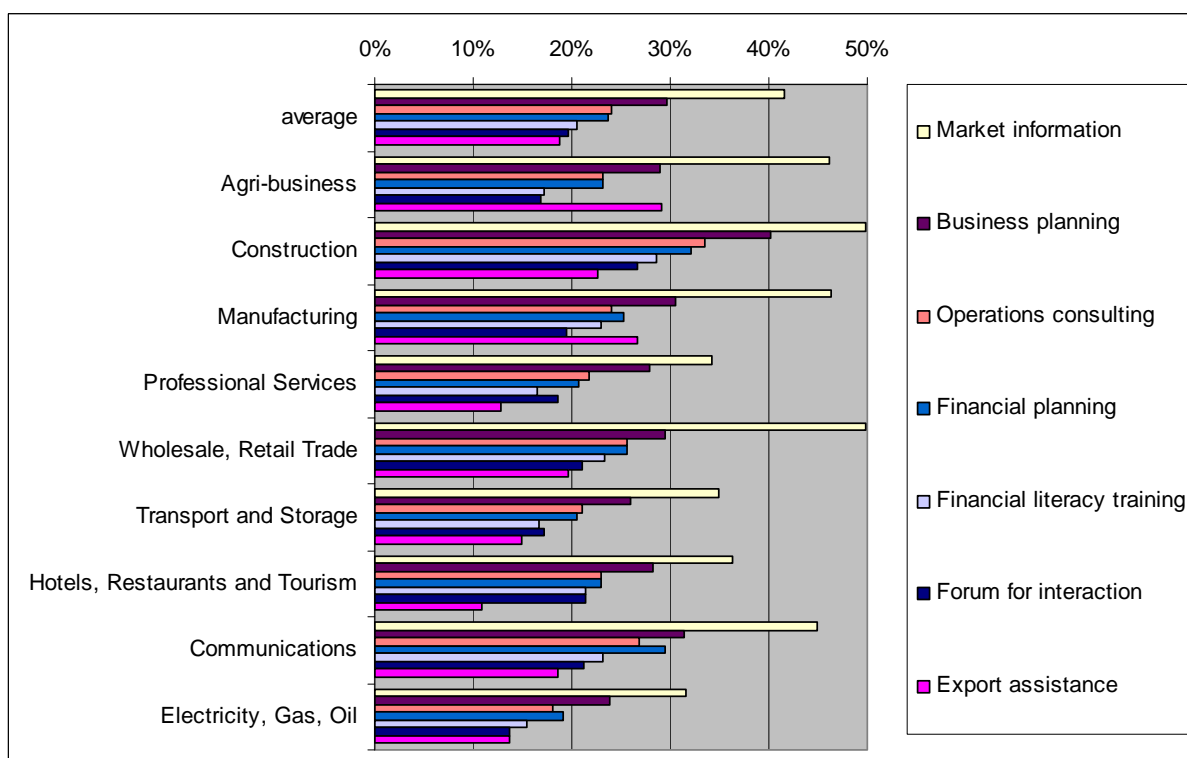




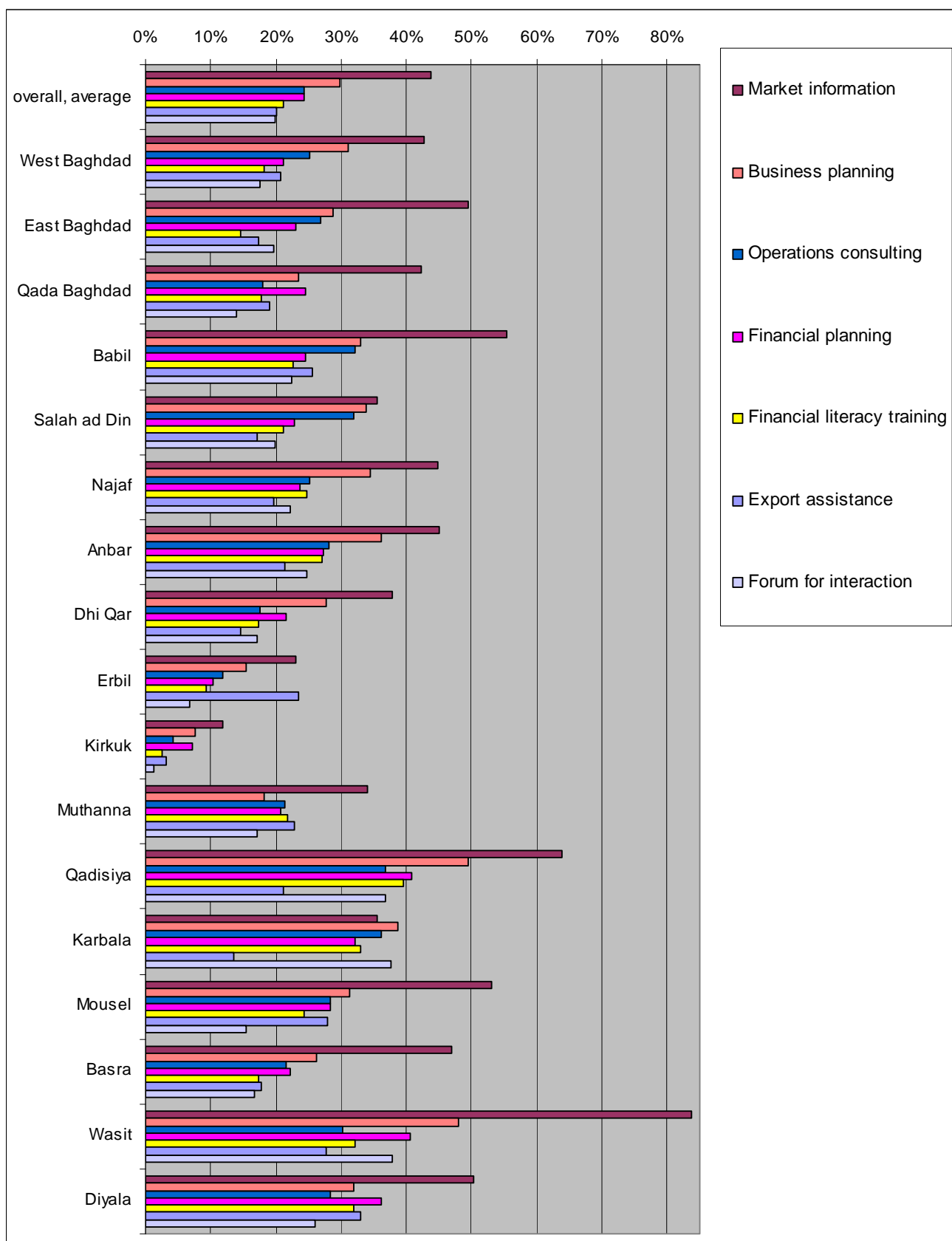
The demand for market information was stronger among the younger and among the better the better educated MSME owners.

**Other bank services demanded by MSMEs**

Other than the case of market information, the demand for non-financial banking services was much lower than for financing. For all non-financial bank services, demand was stronger among the younger entrepreneurs, more educated entrepreneurs and those in the formal sector. Business planning assistance was required by nearly 30% of MSMEs while export development assistance was required on average by less than 20% of MSMEs. Nevertheless, even these levels would guarantee a sizeable market for fee-based services for those banks or other commercial entities that will choose to provide them.

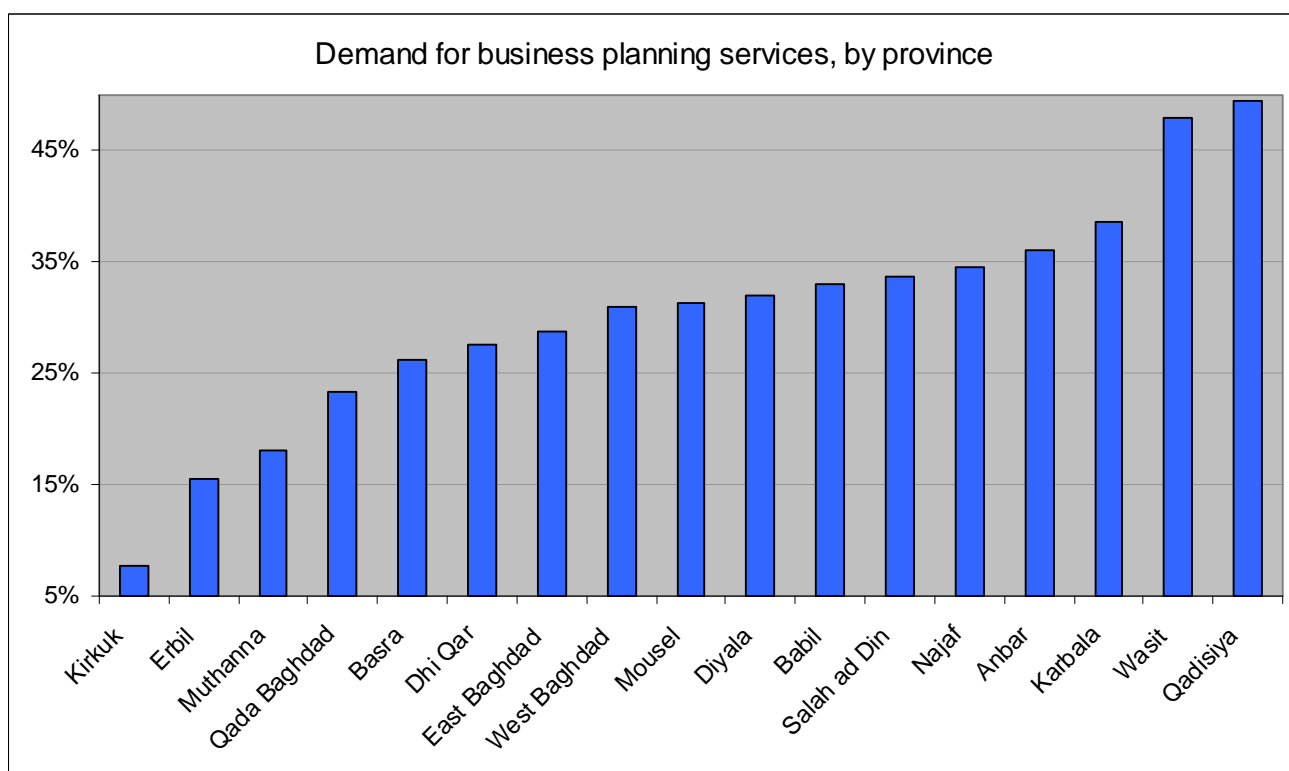
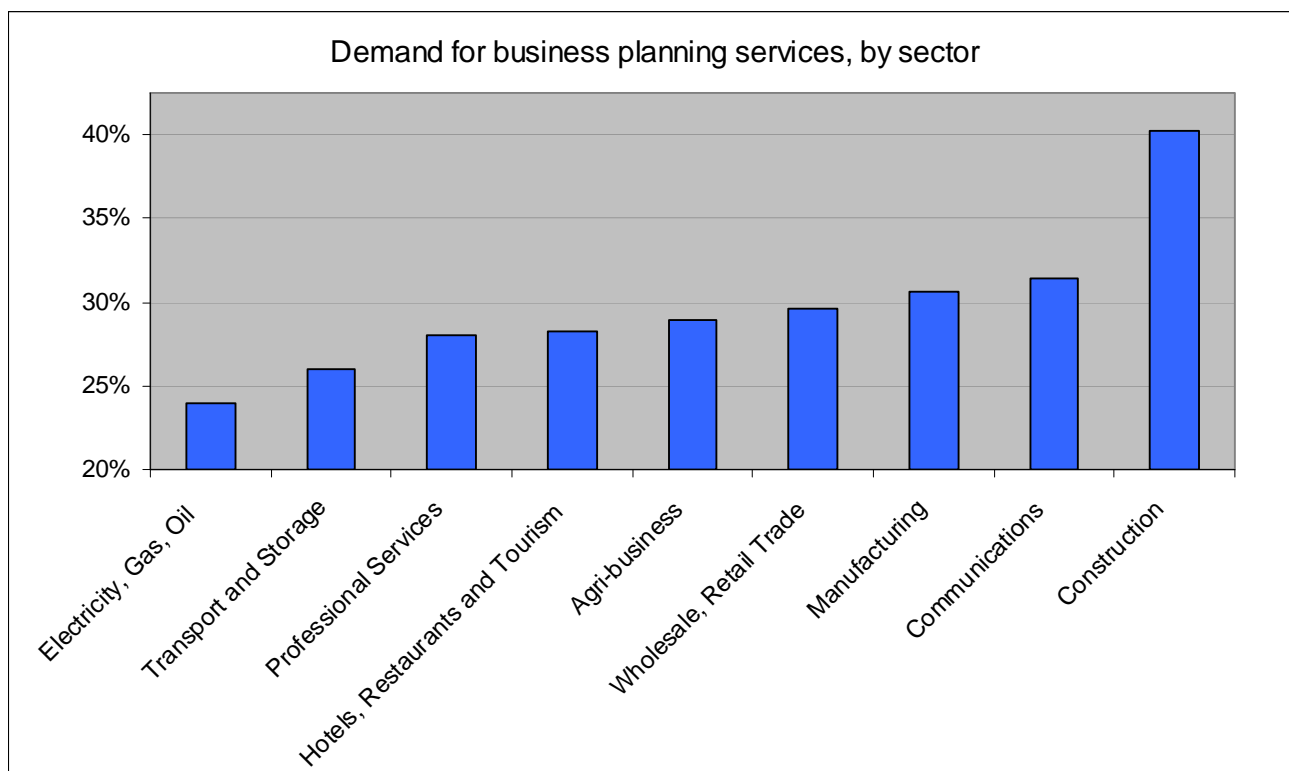


In the table below, demand for various services is listed in descending order based on based on overall average. The province with the highest demand for non-financing services is Wasit, the lowest demand is in Kirkuk.



### Business planning

Business planning was the second most frequently demanded non-financing bank service, after market information.



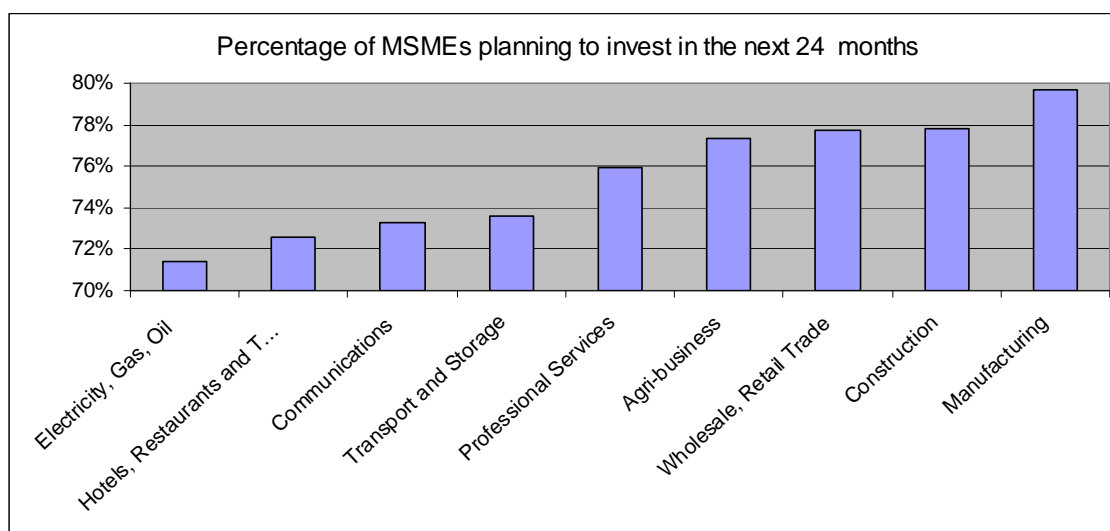
## 1.15 EXPANSION PLANS

MSMEs were asked whether they plan to invest additional capital in their business in the next 24 months.

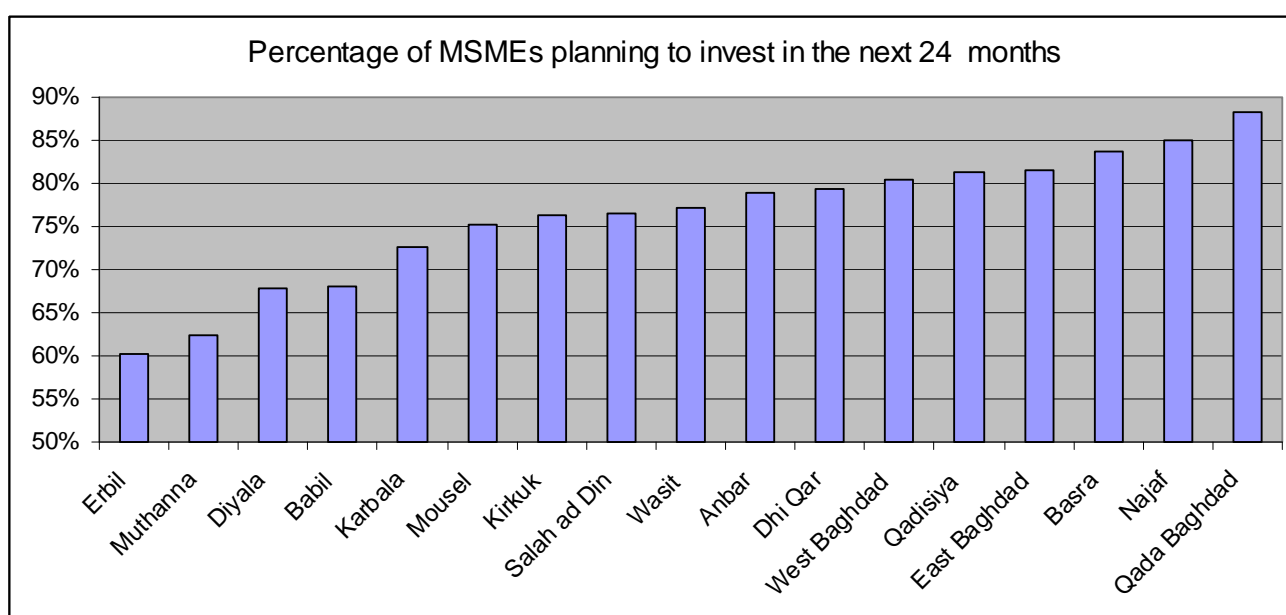
76.9% said yes, 9.5% said no, 13.6% stated that they did not know. These numbers suggest considerable optimism about future business prospects. Even among the MSMEs that were not profitable, 60.1% planned to invest additional capital (as compared to 77.9% of those which declared that they are profitable).

### Industries

The divergence at the level of industry was low, from 71.4% in the energy sector to 79.7% in manufacturing. At the provincial level, the dispersion was greater, with percentages from low sixties to high eighties.



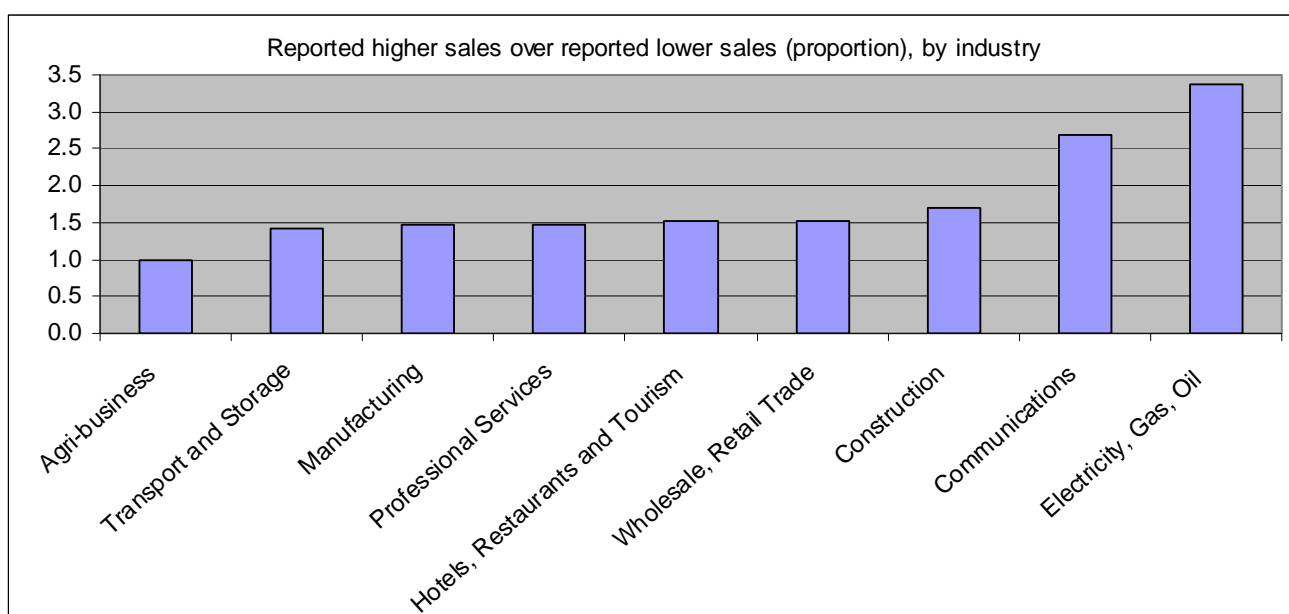
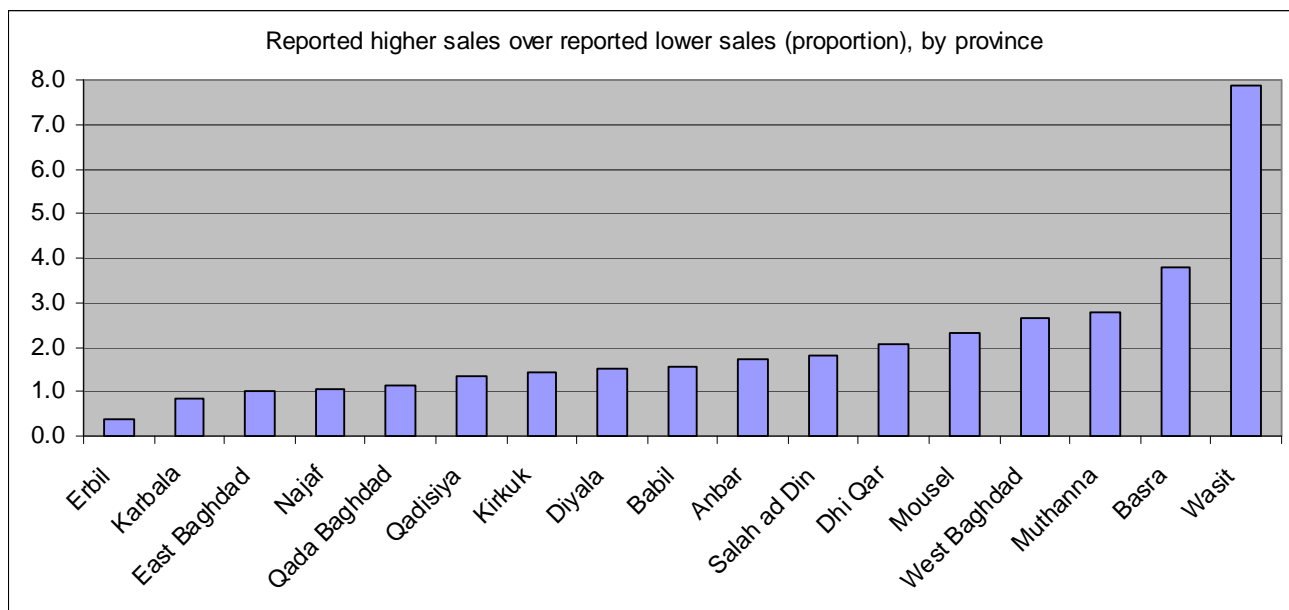
### Provinces



Among those who reported a decline in turnover in the previous year, 73.6% planned to invest (85.5% among those which reported an increase in sales).

### Changes in sales turnover

As changes in turnover are an indicator of the economic performance of an MSME, and therefore of its ability to generate adequate cash flow to enable loan repayments, the graphs below show changes in turnover by industry and province. The number of firms reporting an increase was divided by the number of firms reporting a decrease (MSMEs which reported no change in turnover - 42.2% - were disregarded).

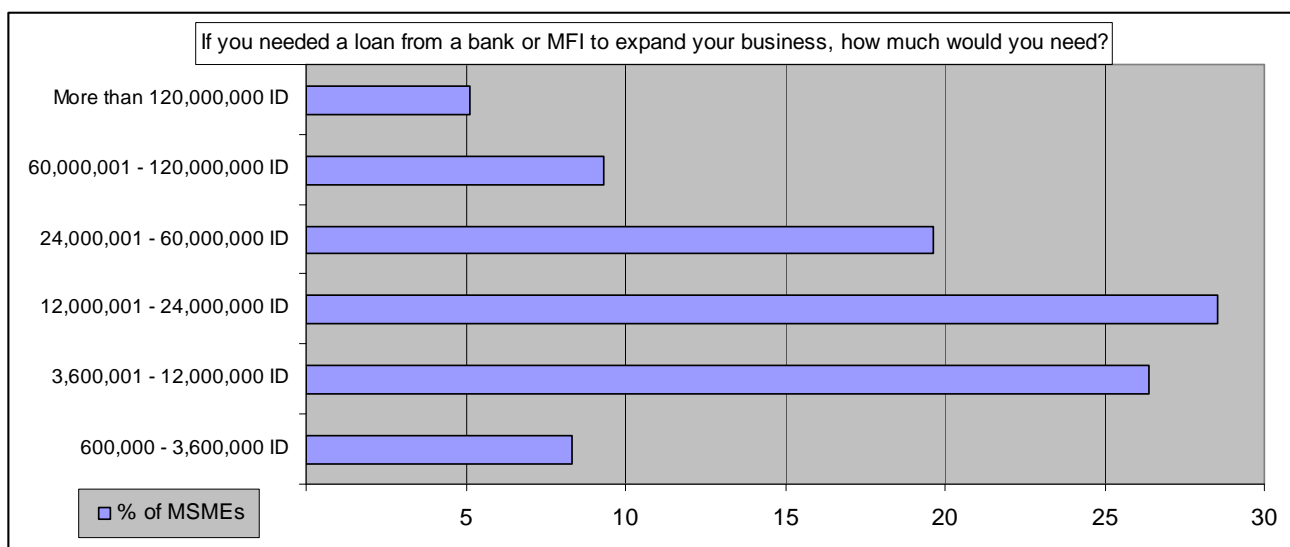


Larger MSMEs reported improvements in sales over the past year more frequently than smaller ones – 37.5% of MSMEs with over 20 employees versus 32.4% of MSMEs with up to ten employees. The ratio of higher to lower sales was 1.66 for the first group and 1.42 for the second group.

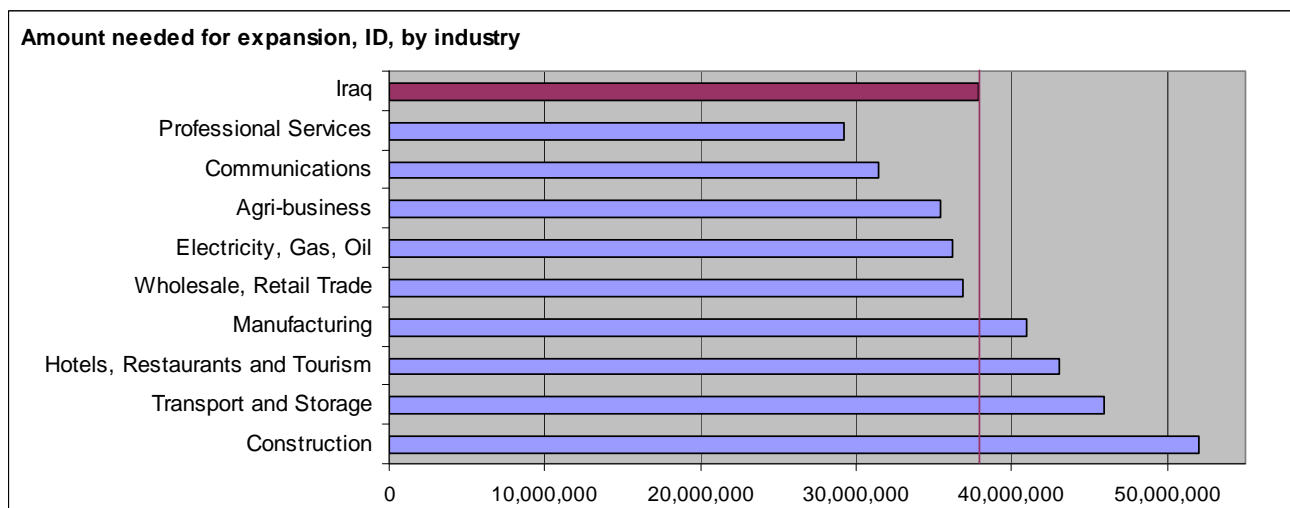
Other than profitability and increased sales, there were no discernible correlations between the intention to make additional investments and other factors.

## 1.16 STATED DEMAND FOR FUNDS

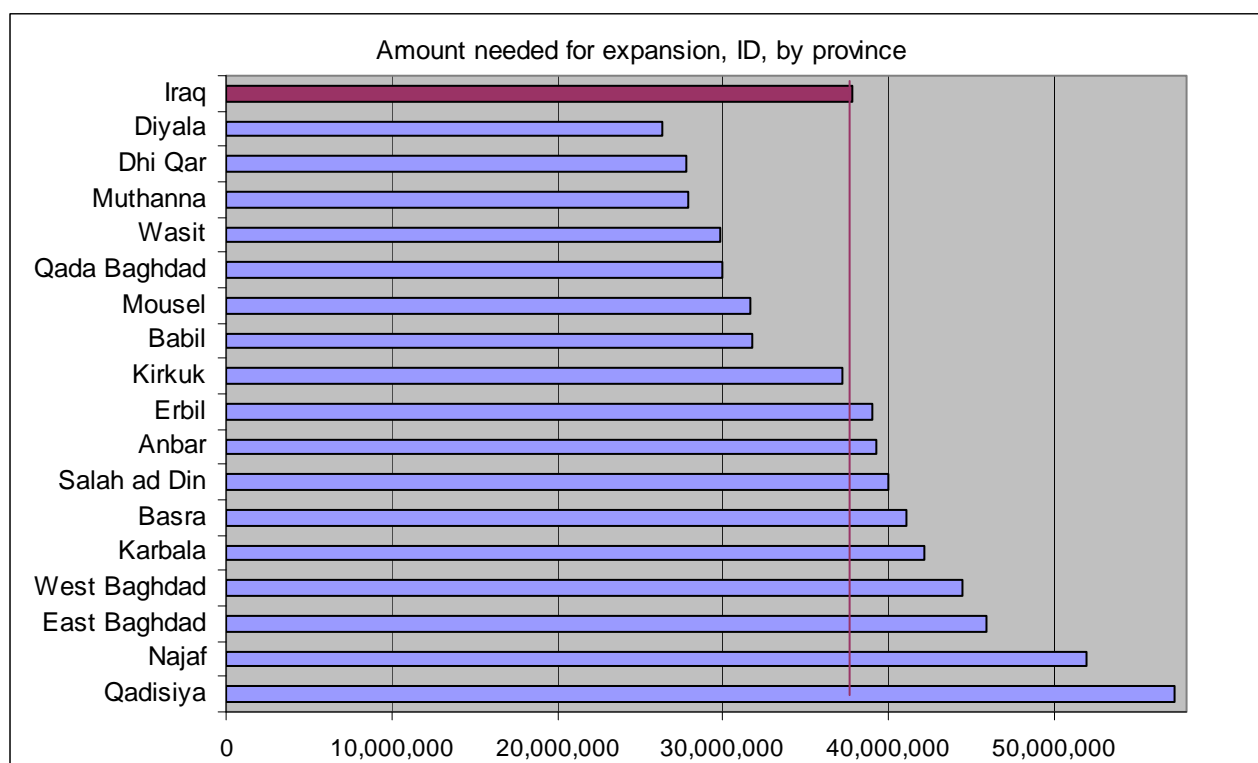
In all, 8737 MSME owners and principals had stated that they plan to invest additional capital in their business in the next 24 months, with another 1542 undecided. MSME owners were also asked “if you needed a loan from a bank or MFI to expand your business, how much would you need?” The table showing the percentage frequency of their responses is below.



Taking mid-interval value in the table above<sup>26</sup>, the total loan demand of interviewed MSMEs would come up to 422 billion dinars, 40.3% of their total current asset value, with an average of 37.8 million ID desired credit per enterprise. Note the stark contrast between average indebtedness at present (3.5 million ID) and the desired loan values.



<sup>26</sup> To overcome the anticipated reluctance and/or inability of MSME owners to provide precise information about their demand for loans, respondents were asked to mark one of several options containing a range of values. Overall values and averages calculated on the basis of taking mid-points of ranges contain an in-built imprecision.



The desired loan amount increases with the size of the firm. Among those with assets up to 10 million dinars, the largest demand (40%) was for loans between 3.6 and to 12 million dinars, among those with assets between 10 and 100 million dinars, the largest demand (35.3%) was for loans between 12 and to 24 million dinars, etc.

Note that the proportion of desired loan size to current MSME's assets is higher among the smaller firms. Whereas the average desired loan size is five times the asset value of MSMEs with assets between 1 and 10 million ID, the proportion drops to 37% for MSMEs with assets between 100 and 250 million ID.

Asset size and desired loan size (ID)	Assets up to 10 million ID	10 million to 100 million ID	100 million to 250 million ID	250 million to 1000 million ID	1000 million to 5000 million ID
Loan size (1) 600,000 - 3,600,000	14%	4.2%	1.7%	3.9%	7%
(2) 3,600,001 - 12,000,000	40%	21%	7.3%	6.8%	1.8%
(3) 12,000,001 - 24,000,000	28.1%	35.3%	19.8%	5.8%	5.3%
(4) 24,000,001 - 60,000,000	11.7%	26.2%	30.5%	26.3%	12.3%
(5) 60,000,001 - 120,000,000	4.7%	9.2%	27.2%	30%	22.8%
(6) More than 120,000,000	1.5%	4%	13.3%	27.1%	50.9%
All loan sizes	100%	100%	100%	100%	100%
Average desired loan size	24.9 mn	39.7 mn	65.2 mn	81.5 mn	104.2 mn

With already indebted MSMEs, appetite for loans, measured by proportion of the desired loan amount to the value of currently held assets, weakened with greater indebtedness.

Average desired loan for all unindebted MSMEs, 39.9 million ID, was 41.2% of their asset average value.

Indebted enterprises averaged 33.7% desired-loan-to-assets ratio. The ratio is inversely related to the size of assets, as can be seen from the table below - average desired loan size for MSMEs with assets of up to 1 million ID was 26 million ID, for MSMEs with assets between 1 and 10 million ID was 35.3 million ID.

Credit indebtedness and desired loan size (ID)						
	no debt	up to IRD 1 Million	1 Million to 10 Million	10 Million up to 50 Million	50 Million up to 100 Million	100 Million up to 500 Million
(1) 600,000 - 3,600,000	8.2%	14.8%	6%	4.5%	6.9%	2.9%
(2) 3,600,001 - 12,000,000	26.1%	37.2%	28.7%	12.5%	9.2%	2.9%
(3) 12,000,001 - 24,000,000	29.2%	26.9%	32.2%	21.8%	12.6%	5.7%
(4) 24,000,001 - 60,000,000	20.1%	13.9%	21.2%	30.4%	25.3%	34.3%
(5) 60,000,001 - 120,000,000	9.9%	6%	8.3%	17.3%	31%	14.3%
(6) More than 120,000,000	6.3%	1.2%	3.3%	13.5%	14.9%	40%
All loan sizes	100%	100%	100%	100%	100%	100%
Average desired loan size	39.6 mn	26 mn	35.2 mn	57.5 mn	66.4 mn	89.6 mn

## 1.17 ESTIMATED SIZE OF MSME MARKET FOR FUNDS

The survey has shown that the demand for loan funds far exceeds the current indebtedness of MSMEs, with an average of 37.8 million ID desired credit per enterprise. We also have responses to the question of how much they would be willing to pay for borrowing, with only 0.7% of businessmen stating willingness to pay interest rates above 10%. While that statistic is hard to take at its face value, for reasons explained in section 1.11, it is nevertheless clear that, faced with commercial interest rates, many MSME owners would be unwilling to take out loans. A more realistic measure of willingness to pay is the proportion of MSME owners reporting having paid interest rates of above 10% on their loans (58%).

Since 11% of MSMEs have had a loan from a bank, a money lender or a microfinance institution in the past, at least 6.4% of MSMEs can be judged to be willing to pay commercial interest rates (11% times 0.58).

How can these numbers be translated into overall demand for commercial lending?

There are no reliable figures about the number of MSMEs in Iraq. With the exception of industrial MSMEs, no MSME census had been undertaken and, in view of informality rates in excess of 70%, such census would in any case be unlikely to produce accurate results. An ILO study undertaken in 2004<sup>27</sup> used data from General Taxation Commission and came up with a mid-range estimate for total number employed in SME sector, both formal and informal, of 4.61 million. The number of SMEs was estimated at 622,000.<sup>28</sup>

We assume that the proportion of MSMEs that wish to expand is the same as in our study – 76.9%. That would mean demand on the part of 478,000 MSMEs of 994 billion ID (\$850 million).<sup>29</sup>

Projections based on a number of estimates and extrapolated indicators are prone to a large margin of error.

Nevertheless, the projection for total MSME demand for loan funds is so much greater than the current MSME lending volumes by private banks that it is clear that private banks face a sizeable potential market opportunity to expand their loan portfolio by lending to clients who have not borrowed from banks in the past as well as by attracting existing users of other financial services (state banks and money lenders)<sup>30</sup>.

<sup>27</sup> “The SME sector in Iraq: A key resource to short-term income generation and longer-term development” by Sanaa Umari and Abbas Abu Altimen, pp 46-105 in “Supporting the Private Sector and Social Partners in Response to Conflicts and Natural Disasters”, HEI-ILO Research Programme on Strengthening Employment in Response to Crises Synthesis Report and Case Studies, Volume I, International Labour Office, Geneva, October 2005. SMEs in the ILO study were categorized by type of activity. Three categories were constructed, each with a different assumed number of workers employed and a different ratio of formal to unregistered businesses.

<sup>28</sup> Excluding 719,800 self-employed, the estimate was for 526,300 entrepreneurs who are likely to employ two people each and 95,700 entrepreneurs in industries where is each likely to employ on average six people.

<sup>29</sup> 622,000 times 76.9% = 478,000 times 6.4% = 30,496 SMEs times 32,600,000 ID = 994 billion.

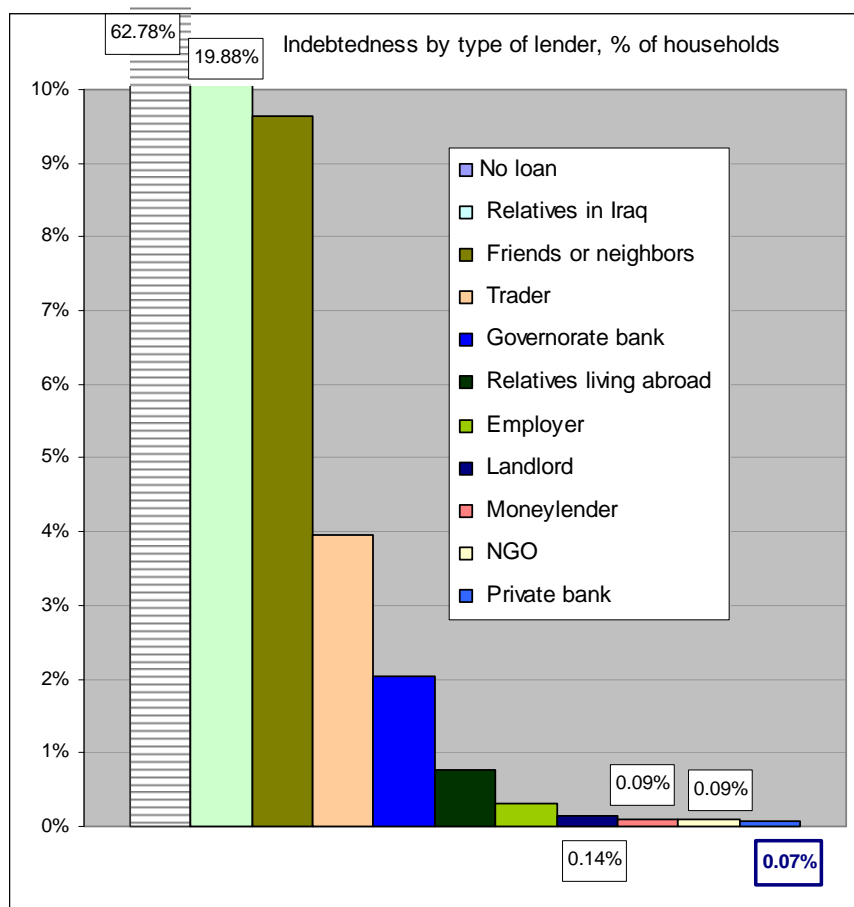
There is a downward bias to this estimate because its base for calculation are only those MSMEs that have received finance already. A high proportion of MSMEs have not attempted to access finance from banks, whether state or private, because of lack of exposure and familiarity with these institutions.

The overall size of SME lending is likely to expand in the future as banks become more comfortable with this segment of the market and as MSMEs learn to become more adept at conforming to banks' expectations in applying for bank credit. USAID in Iraq is working to bring this outcome about by working with private sector banks to increase their SME loan portfolio and by working with SME entrepreneurs, through the Business Development Services Component, to increase their skills in accessing bank finance.

## ATTACHMENT 1: BANK USAGE BY INDIVIDUALS AND HOUSEHOLDS

For the purposes of comparison, a cross-check was made with data on indebtedness of households from the 2007 Iraq Household Socio-Economic Survey (IHSES).<sup>31</sup>

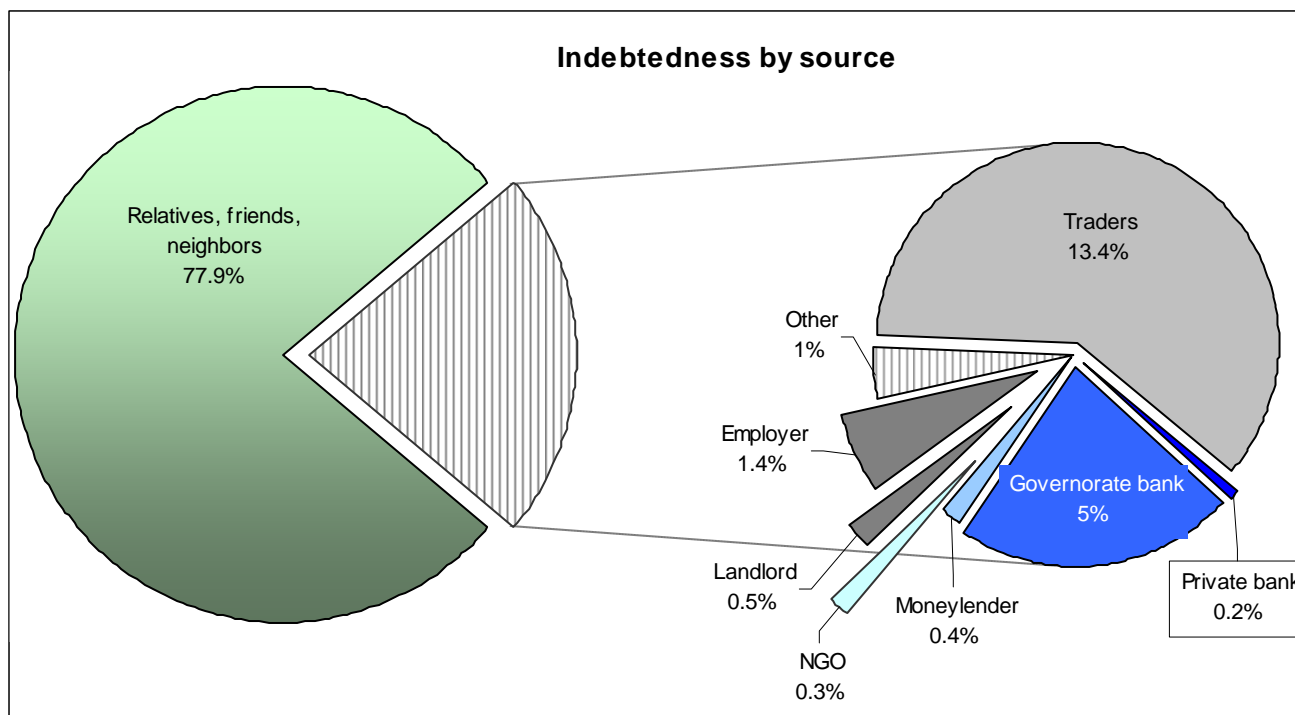
Overall, only 37.6% of households claimed to have any indebtedness at all (among MSMEs, it was 18.35%). As can be seen in the following graph based of Table 10-00 of IHSES, the most frequent external source was credit from traders (3.97%). State banks were next at 2.04%. Private banks placed last with 0.069%, providing only a fraction (3.4%) of overall bank lending.



The following graph looks at the source of loan among those households which are indebted. It has been constructed from data reported in IHSES Table 10-00. IHSES has data on borrowing in three tables – ‘first loan received from...’, ‘second loan received from ...’, ‘third loan received from...’.<sup>32</sup> These three tables have been aggregated to get an overall result by summing up and percentualizing:

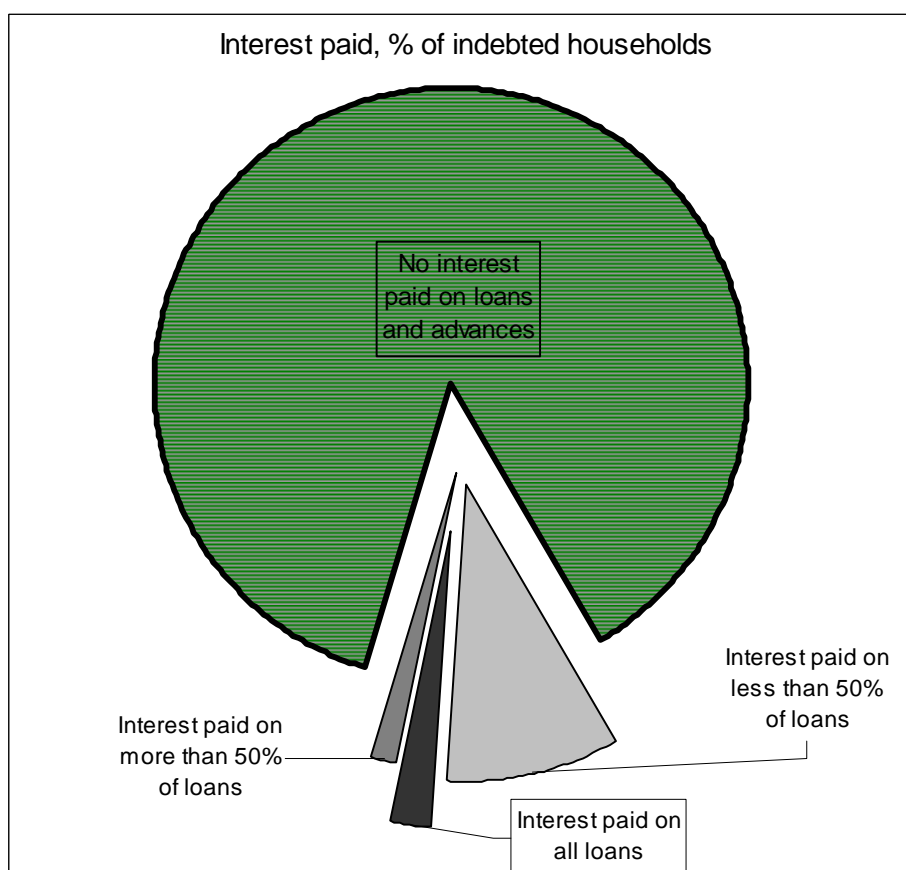
<sup>31</sup> A survey of 127,000 individuals in 18,000 households conducted by the World Bank and COSIT.

<sup>32</sup> IHSES, pages 750-751. Friends or neighbors (32.2%) have been added to relatives abroad (2.29%) and relatives in Iraq (43.42%) to form one category. The distribution in the three groups varied slightly. In the case of a second loan, 20.4% of all cases, the most common category were ‘friends and neighbors’ (58%), for the third loan, 2.2% of all cases, the most common category was the trader financing (41%).



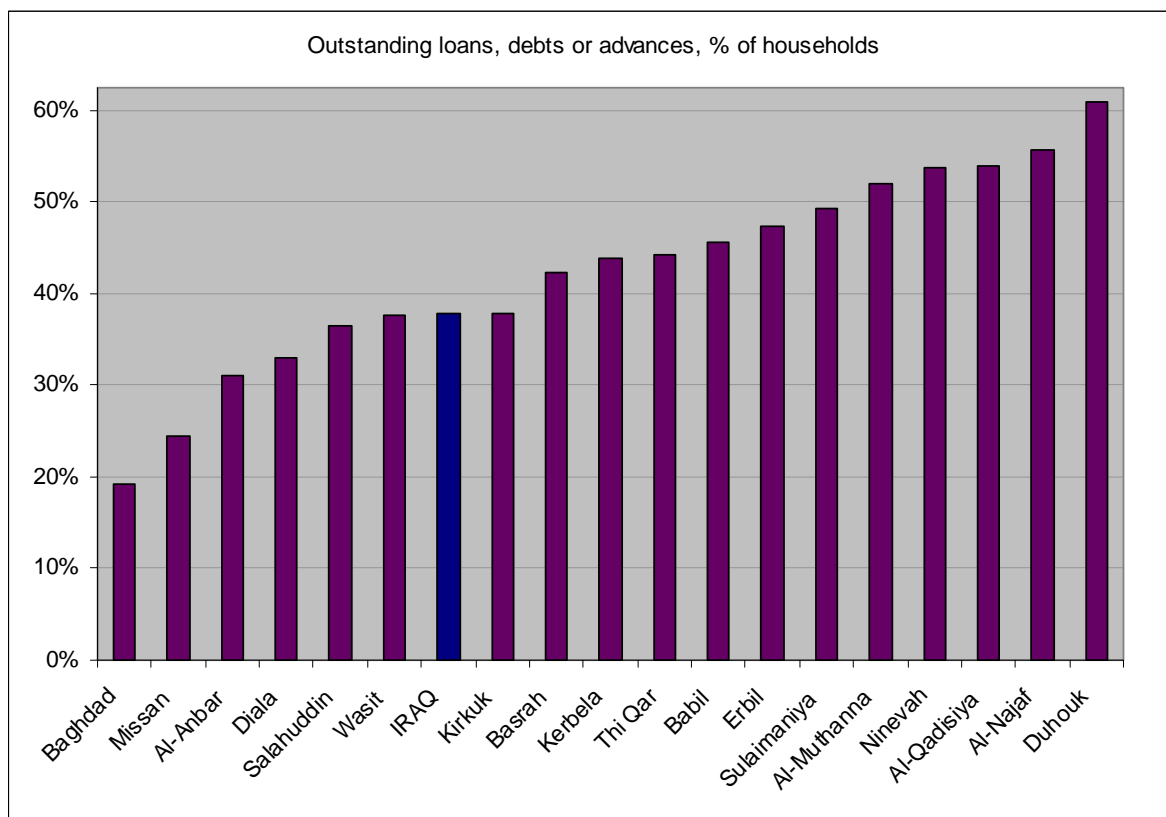
As can be seen from the graph above, bank finance from private banks is much lower at 0.2% than borrowing from state banks (5%).

**Nearly 87% of indebted households pay no interest on any of their loans.** Most of these loans would come from relatives, neighbors and friends. However, as these sources together amounted to 81.33% for the first reported loan, it is clear that no interest was paid on borrowing from some of the other sources as well.<sup>33</sup>



<sup>33</sup> The data does not enable an identification of these sources.

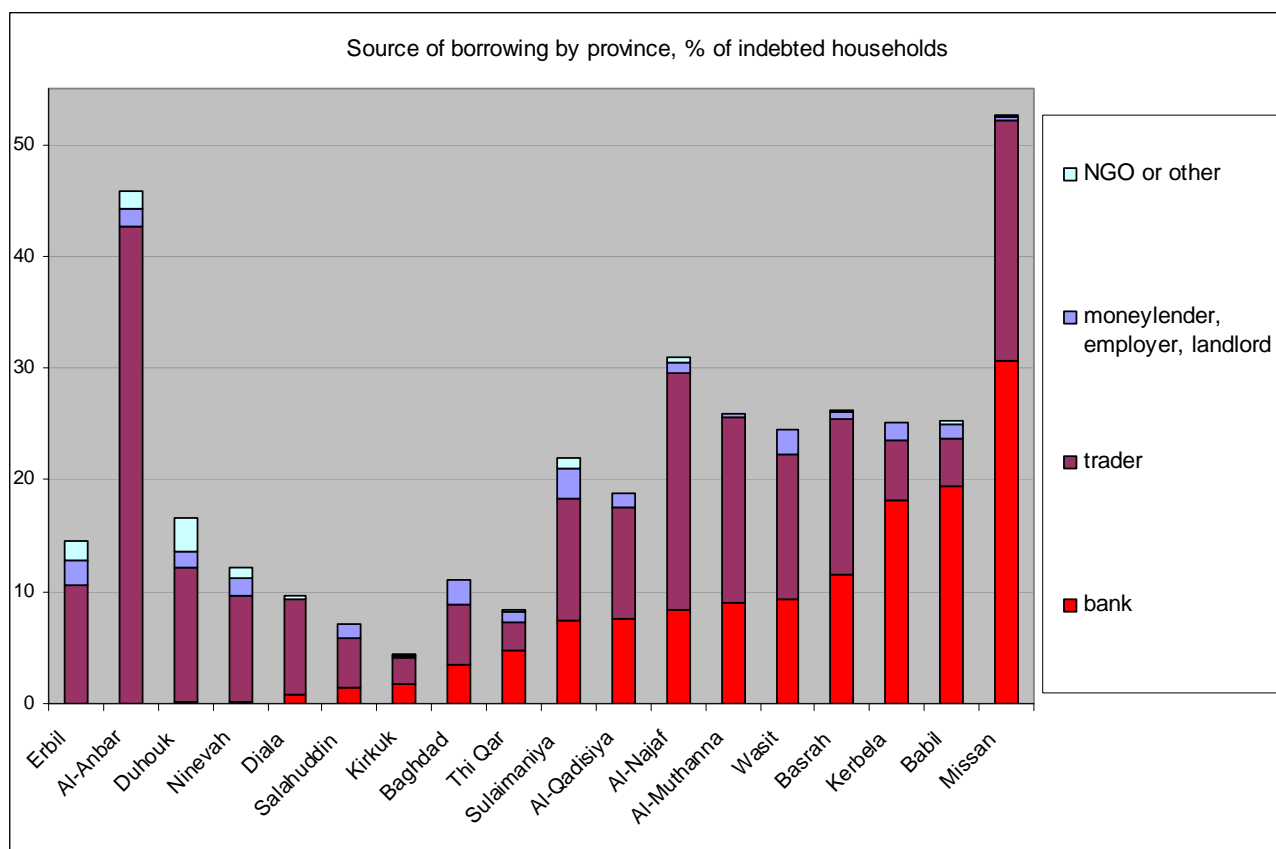
The extent of indebtedness varied geographically, with Dohuk reporting indebtedness most frequently and Baghdad least frequently.



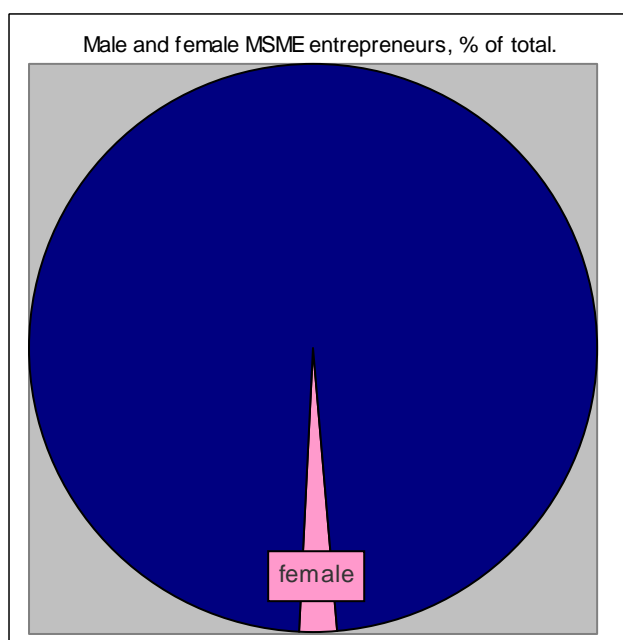
Within the provinces, the sourcing of loans differed. For example, in Anbar trader credit accounted for 42.6% of credit and there was no bank financing while in Babil trader credit accounted for only 4.3% of credit loans and bank financing for 19.4%. The Table below is sorted based on column 5 (banks) in ascending order.

Source of credit, in percent	relatives, friends, neighbors	moneylender, employer, landlord	trader	bank	NGO or other	total
Erbil	85.5	2.2	10.6	0	1.8	100
Al-Anbar	54.1	1.7	42.6	0	1.5	100
Duhok	83.3	1.5	12	0.1	3	100
Ninevah	87.9	1.5	9.5	0.2	1	100
Diala	90.3	0	8.6	0.8	0.3	100
Salahuddin	92.9	1.2	4.4	1.5	0	100
Kirkuk	95.7	0.1	2.4	1.7	0.2	100
Baghdad	88.9	2.2	5.5	3.4	0	100
Thi Qar	91.6	0.9	2.6	4.7	0.2	100
Sulaimaniya	78.1	2.7	10.9	7.4	0.9	100
Al-Qadisiya	81.3	1.3	9.9	7.6	0	100
Al-Najaf	69.1	0.9	21.3	8.3	0.4	100
Al-Muthanna	74.1	0.3	16.6	9	0	100
Wasit	75.5	2.2	12.9	9.4	0	100
Basrah	73.7	0.6	14	11.5	0.2	100
Karbala	74.8	1.5	5.4	18.2	0.1	100
Babil	74.7	1.2	4.3	19.4	0.4	100
Missan	47.4	0.4	21.4	30.7	0.2	100
IRAQ	81.4	1.4	10.7	5.9	0.6	100

The graph below shows data from the above table (other than relatives, friends and neighbors), sorted in ascending order of banking finance. Missan province shows the highest proportion of finance from banks.

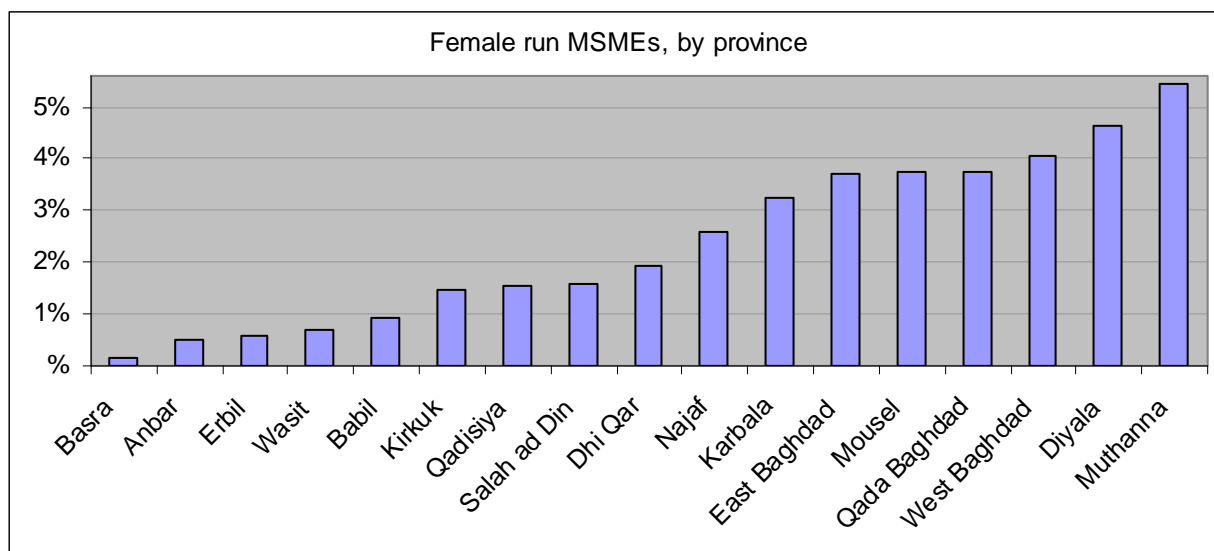


## ATTACHMENT 2: CHARACTERISTICS OF IRAQI FEMALE SME ENTREPRENEURS



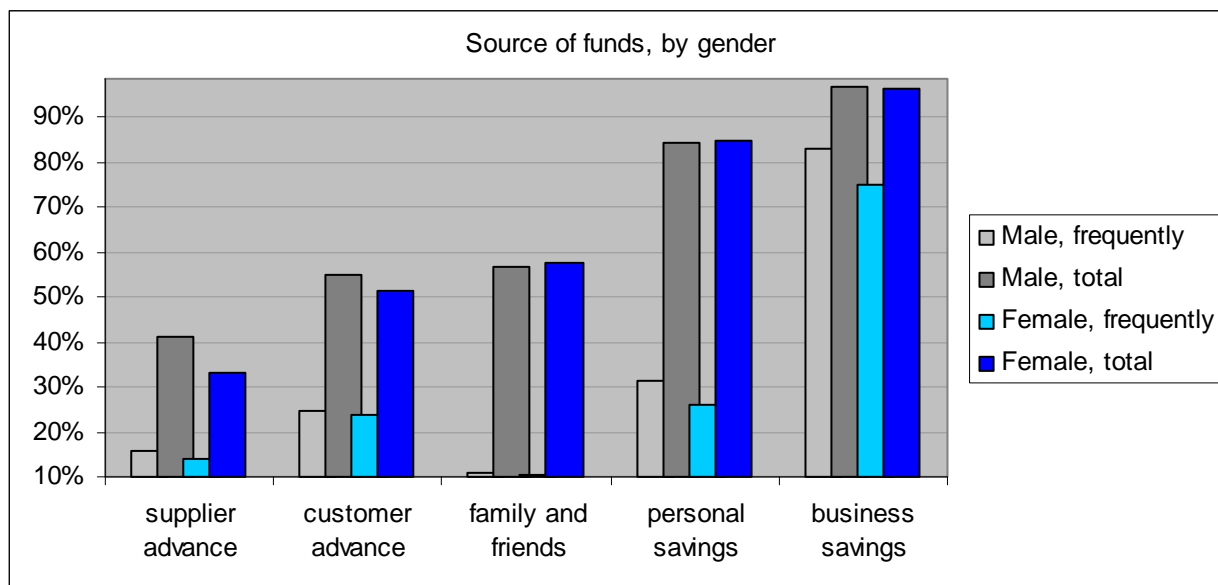
The survey had revealed an extremely low rate of MSME ownership by women – 2.3% (267 out of total 11,440 MSMEs).<sup>34</sup>

Regionally, this proportion varied from 0.2% in Basra to a still very low 5.4 % in Muthanna.



On a frequent funding basis, female-run MSMEs showed a higher frequency of funding from new partners, microfinance and money lenders. On a total funding basis, female MSMEs showed a higher frequency of funding from new partners, money lenders, personal savings and family and friends.

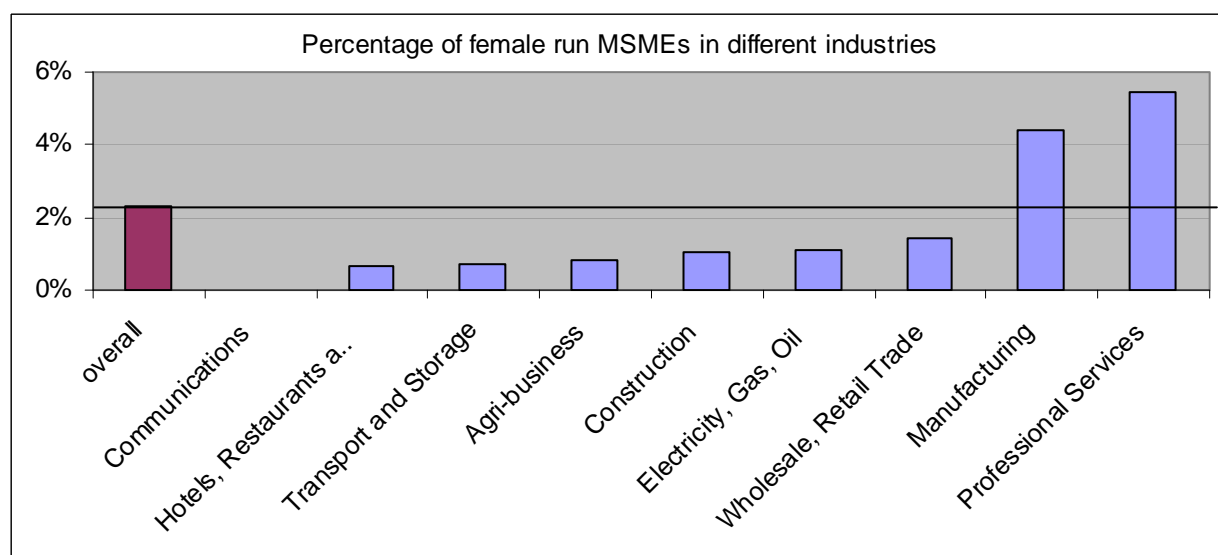
<sup>34</sup> The chain referral method of selecting respondents may have biased the numbers downwards, with the greater reluctance of females to take public profile also playing a role.



Average reported credit indebtedness was extremely small compared to male entrepreneurs: 477,000 ID versus 3,600,000 ID. Average reported credit indebtedness for indebted enterprises was also disproportionately small compared to male entrepreneurs: 3.7 million ID versus 19.6 million ID.

Average desired loan size is 29.6 million ID (versus 38 million ID for males)

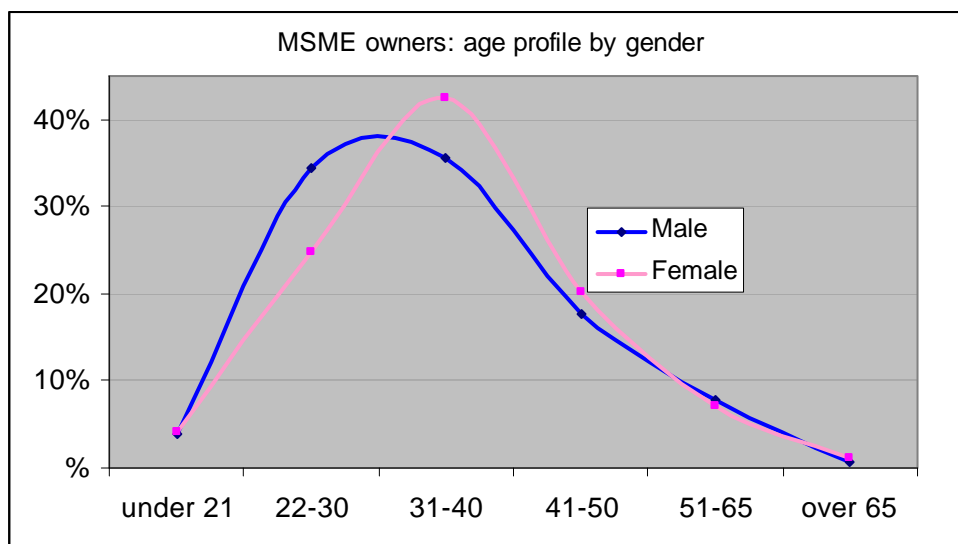
Because there is almost no data about the characteristics of female entrepreneurs in Iraq, it may be useful to mention several of the findings even at the cost of diverging somewhat from the subject matter of this study.



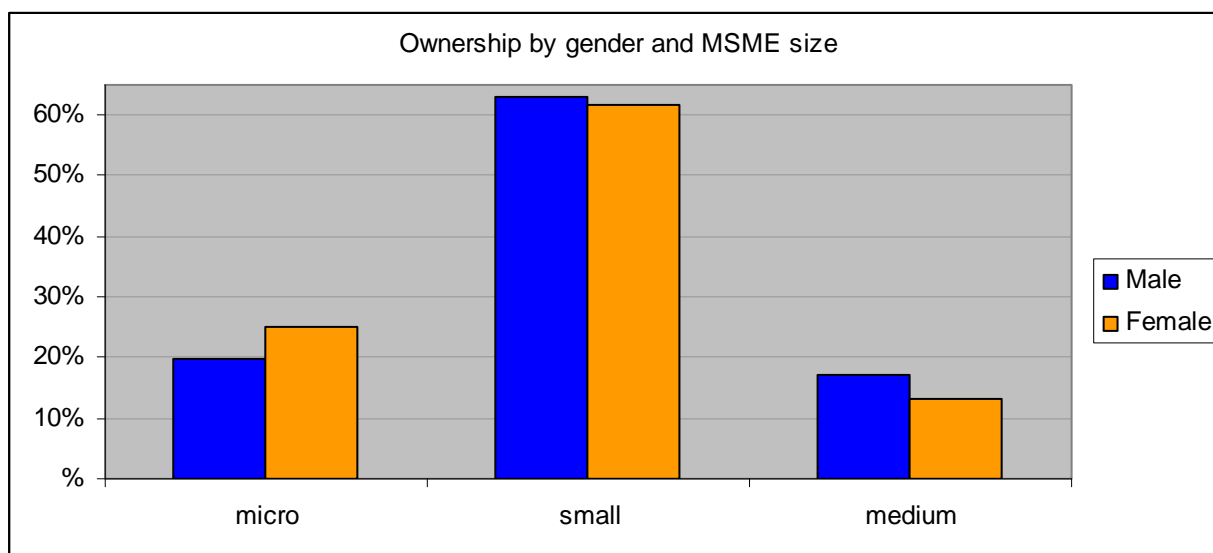
Iraqi MSMEs led by female entrepreneurs:

- have a higher informality rate (77.1% versus 72.6% for male owned MSMEs)
- rate of membership in professional associations is similar but their membership in business associations is lower (11.2% versus 17.5%)
- computer ownership is lower (11.4% versus 17.6%)
- have been in business for a shorter period of time

- the average length of operations of female run MSME is three years less (5.3 versus 8.3 years)
- 70% of female run businesses have been established in the last five years (versus 51%)
- average asset value is less than half of male MSMEs (42 million ID versus 100 million ID)
- average turnover is one third of male turnover (21.7 million ID versus 64.5 million ID)
- average age is the same as for male entrepreneurs but the age profile is somewhat different:



Using the employment size classification used by Market Assessments, we can look at the ownership by gender. It can be seen that microenterprises were more common among women (25% of all women owned MSMEs).



Female entrepreneurs appeared to be more successful in their business activities. Percentage of females reporting declines in turnover was less than one half of the male figure and the ratio of increases to declines was 3.:1 compared to only 1.45:1 for males.

