V. BANKING SUPERVISION AND REGULATION

Over the past years, Iraq has benefited from a significant amount of technical assistance in banking supervision. It currently has the main elements in place of a legal and regulatory framework that allows for sound banking supervision, given the current state of development of the banking system. However, the Head of the Supervision Department acknowledges the need for significant training to effectively implement the new regulations. And more disturbingly, it is alleged by senior officials at the CBI as well as market observers that CAMELS ratings can be subject to undue influence by banks, which implies potential governance problems.

Three conditions must be stressed. First, it is essential that the political will is confirmed to let the CBI exercise banking supervision using its full powers under the laws and regulations, and its professional judgment without any interference. Second, in particular, the 2006 Memoranda of Understanding between the CBI and the Ministry of Finance to the effect that the CBI shall exercise supervision of the two main state owned banks, Rafidain Bank and Rasheed Bank, are faithfully implemented. And third, the CBI should have the resources and expertise to be able to exercise authoritative supervision. At this time, the Ministry of Finance continues to determine the key policies and practices of these two banks, and the CBI cannot effectively supervise these banks. No conclusive information was available to the mission how Rafidain Bank and Rasheed Bank are supervised. Market observers point to similar concerns over the lack of effective supervision of TBI. The fact that the CBI is unable to exercise effective supervision over Rafidain Bank and Rasheed Bank implies that by far the greater part of the banking system in terms of assets is not under effective CBI supervision.
Reliable information on the capital position of Rafidain Bank and Rasheed Bank is not available. Private banks report adequate capital, against a statutory minimum risk weighted capital adequacy ratio of 12 percent. However, three private institutions have CAMEL ratings of four or five, at the lower end of the scale, requiring constant CBI supervision and intervention. A significant number of banks have 3-ratings, which also implies the need for keen vigilance to prevent further slippage.

A. Assessment of the Effectiveness of Banking Supervision

1. Preconditions for Effective Banking Supervision

Macroeconomic Stability

Although Iraq’s overall economic growth prospects are favorable, risks to the economic development process include political factors, security issues, technical capability, governance weaknesses and institutional capacity issues to implement reforms. Real GDP growth rate fell from around 9.5 percent in 2008 to 4.2 percent in 2009 due to the slump in oil revenues. Macroeconomic stability in Iraq depends heavily on the stability of oil revenues. Growth rates declined further in 2010 but are expected to pick up in 2011, driven mostly by the oil sector. Revenues from crude oil exports account for about two-thirds of the country’s GDP and for almost all of its export and fiscal revenues. The CPI increased by 3.3 percent in 2010. As of April 1, 2010, the CBI lowered the policy interest rate from 7 percent to 6 percent and reserve requirements from 25 percent to 20 percent. Gross international reserves of the CBI increased from US$ 44.3 billion at end-2009 to an estimated amount of US$50.6 billion at end-2010. The accumulation of foreign exchange reserves at the CBI allowed Iraq to stabilize the Dinar, reverse the dollarization process, and contain inflation. Since early 2009, the exchange rate has been kept at ID1170 per US dollar. Total external debt has decreased from 137.9 percent of GDP in 2009 to 106.7 percent of GDP in 2010, and is projected to decline further to 37.1 percent and 32.6 percent of GDP in 2011 and 2012, respectively.

Public Infrastructure

The legal framework for financial business shows serious lacunae, e.g. the absence of a general insolvency law, which makes loan collection for banks more challenging, while judicial loan enforcement proceedings even for simple claims can take several years to be completed. The Law on the Central Bank of Iraq and Banking Law contain provisions for the creation and functioning of a Financial Services Tribunal. The Banking law provides detailed rules on conservatorship, resolution and insolvency. A civil code and a companies’ law are in place. There is no collateral registry, which is indispensable for the reliable functioning of mortgage credit. Iraq ranks 141 out of 183 in contract enforcement, according to the World Bank publication “Doing Business 2010”.

13. For more detail, see Annex 7 “Assessment of Banking Supervision.”
Effective Market Discipline

However, currently a draft law on deposit insurance, prepared by the CBI and the banks, is being discussed in the State Consultative Council. Market discipline in Iraq faces a number of serious challenges: (i) Iraqi accounting standards are not consistent with IFRS, (ii) notwithstanding a legal obligation many companies, including banks, do not publish financial statements, or they are very difficult to obtain, and (iii) there are insufficient numbers of qualified public accountants in Iraq. General consumer protection rules do not exist in Iraq, other than the general civil code rules, nor is there a system for depositor protection.

Moreover, financial information on Rafidain Bank and Rasheed Bank, which dominate the system, is unreliable, pending the ongoing regularization of the balance sheets of these institutions, which, moreover, are not compiled according to IFRS. Also, it is assumed that these banks enjoy a de facto guarantee from the state. Market discipline with regard to these banks is therefore not effective.

Stock market analysts do, however, publish analyses of private bank stocks quoted on the Iraqi stock exchange, notwithstanding the unavailability, in many cases, of up to date, audited, balance sheet and income statement data. The CAMELS ratings of banks are routinely disclosed to the public by the CBI. The majority of the population still holds their deposits in the state owned banks, given their de facto government guarantee.

Bank Resolution

The CBI has a credible legal and regulatory framework to apply remedial measures, resolve banks, and initiate liquidation through a judicial process, and the CBI has taken corrective actions against small private banks in a number of cases. The remedial measures enumerated in the law include sending a warning, giving an order, requesting from the bank a program of remedial measures, issuing cease and desist orders, imposing restrictions on credit operations, keeping supplementary liquidity at the CBI, suspension of managers or Board members, dissolving the Board, imposition of monetary penalties, withdrawal of the license, and liquidation (through the Financial Services Tribunal).

Article 59 of the law provides a basic form of prompt corrective action, imposing on the CBI the obligation (when capital falls below 50 percent of the required minimum) or the discretion (when capital falls below 75 percent of the minimum) to impose conservatorship. Article 56 of the Banking Law (2004) authorizes the CBI to take any measure or impose an administrative penalty for violation of the law or regulations, or the unsafe and/or unsound conduct of banking business. The latter criterion shows that the CBI has the authority to make qualitative judgments, rather than be purely compliance-based.

The law authorizes the CBI to set up a bridge bank for a maximum of two years, plus a maximum of three one-year extensions. A moratorium may be imposed by the CBI to protect the financial condition of a bank in conservatorship. Banks are not subject to general bankruptcy law.
B. Supervisory Rules and Practices

1. Objectives, Independence, Powers and Resources

The legal and regulatory texts clearly describe the objectives of banking supervision, and provide for a good measure of formal independence of the CBI as the supervisory agency, as well as adequate powers. There are a number of anecdotal indications, however, that the independence and powers of supervision are limited, in particular with regard to the state owned banks, and that current resource levels may not be adequate at this time to include full rigor supervision of the large state owned banks and a potentially growing banking system. The CBI’s remedial powers should also be used more forcefully.

Objectives: The basic regulatory and supervisory responsibilities of the CBI are laid down in Article 4 of the Law on the Central Bank of Iraq. Article 3 Law on the Central Bank of Iraq states that maintaining a “stable and competitive market based financial system” is one of the “primary objectives” of the CBI. Article 2 of the Banking Law (BL) states that regulatory objectives include promoting public understanding of the banking system, inter alia by maintaining an appropriate degree of protection for depositors and helping reduce financial crime including fraud, money laundering and terrorist financing. The CBI also exercises supervision over some 1750 other financial institutions. These include exchange bureaus, money transmission services, investment companies, lending operations of insurance companies, pension funds, microfinance institutions and the post office’s depository operations, as well as commercial companies with credit facilities for their staff. The Banking Supervision Department also deals with consumer complaints with regard to financial services.

Independence: Article 2(2) Law on the Central Bank of Iraq states that the CBI shall be autonomous and accountable as provided for by the law, and stipulates further that except as otherwise specified in the law, the CBI shall not take instructions from any other person or entity including government entities. The governor is nominated by the Head of Government, and confirmed by the Legislature for a five year term of office, which can be renewed. The governor cannot be dismissed, except by the Head of Government, only for one of the reasons explicitly listed in Article 14(2) Law on the Central Bank of Iraq. These grounds include conviction of a criminal offence, bankruptcy, mental or physical infirmity, absenteeism and personal misconduct. A decision of removal from office, as well as the grounds upon which this decision rests, must be publicly disclosed and are subject to appeals at the Court of Cassation.

Article 55 Banking Law stipulates that CBI officials or staff shall not be personally liable for damages for any act or omission committed in the discharge of official functions, including banking supervision. The CBI shall indemnify officials or staff for the legal expenses incurred in the defense against legal action brought against them.
Box 5.1: Supervision and Restructuring of Rafidain Bank and Rasheed Bank

Normalization of the position and activities of Rafidain Bank and Rasheed Bank is seen by the authorities as crucial to the development of a banking system that could support the growing economy of Iraq.

In Memoranda of Understanding of 6 December 2006, the CBI and the Minister of Finance laid down the framework for the supervision and operational and financial restructuring of Rafidain Bank and Rasheed Bank.

However, the Iraqi authorities have recently postponed the recapitalization of both banks to 2013, seven years after signing of the MOUs. It is widely acknowledged by most Iraqi counterparts in the financial sector that the MOUs have not been implemented. In particular, counterparts agree that effective banking supervision by the CBI over these two banks has not been possible.

Main elements of the MOUs are:

- Achieve normalization of Rafidain Bank and Rasheed Bank through operational and financial restructuring, to prepare them for a competitive market economy, and ensure their long-term financial viability;
- Complete an operational audit by July 31, 2007, consisting of a review of the Bank’s products, operations, policies, and procedures, as a basis for a new, commercially-oriented business strategy.
- Continue regular banking supervision by the CBI, applying normal prudential requirements, but taking into account the temporary forbearance granted by the MOUs.
- In particular, the MOUs specify that in case of non-implementation of the MoU, or excessive delays, the CBI has the authority to impose conservatorship.
- Apply strengthened corporate governance to Rafidain Bank and Rasheed Bank, by requiring them to adhere to OECD/World Bank Corporate Governance Guideline.
- Use Treasury bonds to recapitalize the bank.
- Identify all banking activities undertaken for the Government by these banks and charge market rates for these services.

Powers: Article 59 of the law provides a basic form of prompt corrective action, imposing on the CBI the obligation to appoint a conservator when capital falls below 50 percent of the required minimum. It has the option to do so when capital falls below 75 percent of the minimum. Article 56 of the Banking Law 2004) authorizes the CBI to take any measure or impose an administrative penalty for violation of the law or regulations, or the unsafe and/or unsound conduct of banking business. The latter criterion allows the CBI to make qualitative judgments, rather than be purely compliance-based.

The law authorizes the CBI to set up a bridge bank for a maximum of two years, plus a maximum of three one-year extensions. A moratorium may be imposed by the CBI to protect the financial condition of a bank in conservatorship.
Article 40 of the Law on the Central Bank of Iraq provides exclusive authority to take all such actions as may be necessary to license, regulate and supervise banks and their subsidiaries. The CBI has the authority to conduct off-site surveillance and on-site examination of licensees and their subsidiaries, and require banks to provide all information the CBI may request, and to take remedial action to enforce compliance with prudential standards.

Article 42 of the Law on the Central Bank of Iraq authorizes the CBI to examine evidence with regard to suspected activities for which a CBI license is required, if necessary with the assistance of law enforcement officials. The CBI shall order cessation of such activities, and if necessary impose penalties. Article 62 permits imposing penalties on natural persons responsible for the breaches of the rules. Article 3(1) Banking Law prohibits the exercise of banking activities without a CBI license. Article 3(4) Banking Law prohibits the use of the word “bank” without having a banking license.

Resources: At this stage of development of the banking system, it is critical that the CBI maintain the public confidence in the banks. This requires a higher than average level of supervisory resource allocation in the medium term. The CBI currently has staff of around 1600, down from approximately 2650. Counterparts have stated that the governor of the CB intends to decrease the number of staff further, to around 500. However, under those conditions resources may become over-stretched in the coming years, as foreign banks are showing increasing interest to enter the Iraqi market as the security situation improves, and the state owned banks will become subject to CBI supervision. This will lead to an expected increase in the need for qualified supervisors. There is also considerable scope for an increase in the number of bank branches, which currently stands at 1/40,000 inhabitants, whereas in the industrialized world, this figure averages at 1/10,000. The budget of the Banking Supervision Department has been steadily increasing by around 10 percent per year.

Under Article 2 (1) CBIL, the CBI determines its own budget and funding, may administer and hold property, hire staff and define their duties. The banking supervision department, headed by a director general, has total staff of approximately 235, of which 135 at Baghdad headquarters, and 100 spread over the four branches of the CBI in Basra, Mosul, Arbil and Suleymaniyeh.

Professional level banking supervision staff is required to have a bachelor’s level education in banking, finance, law, accounting or IT (the latter for quantitative and off-site functions). Staff is provided with continued domestic and external training.

2. Licensing, Ownership and Acquisitions

Licensing: Although the licensing framework is adequate, there is a need for better arrangements for cooperation with foreign supervisors, also with regard
BANKING SUPERVISION AND REGULATION

To ongoing supervision, as more foreign banks show interest for entry into the Iraq market. Banking Law Section 2, Articles 4-13 regulate the licensing process, and provide the legal basis for more extensive CBI regulations on the licensing process for domestic and foreign banks, subsidiaries, bank holding companies, branches, and representative offices. These regulations have recently been revised in January 2011.

For domestic banks the licensing process is divided into two phases. During the first phase, the applicant must submit inter alia a three year feasibility study/business plan with pro-forma balance sheets, income statements and an organizational chart. At least two shareholders must have banking experience.

Foreign shareholders are permitted, if they are a bank and are subject to banking supervision in their home country. If shares are owned by a corporate entity, audited balance sheets and income statements over the past three years, “or whatever is available”, need to be submitted. This requirement needs to be made more precise, the requirement to provide “whatever is available is too open-ended”. The request for the final license must be accompanied by information on the shareholders, Board of Directors, and the CEO.

Foreign applicants must have an international credit rating, implying that only reputable banks can apply for a license. The founding foreign bank must show proof that it is subject to consolidated supervision in its home country and has been in business for at least three years. A foreign bank must also submit an overview of the institution’s banking products, an assessment of the risks in the bank’s plan, the IT to be deployed for work in Iraq, and the number of Iraqi employees and details about their training. Also, the home supervisor must confirm that it is in a position to exercise remedial powers over the branch. During the licensing process the CBI contacts the home supervisor of a foreign bank, usually through an exchange of letters, in the absence of a formal system of MOUs.

Ownership: The rules on acquisition of significant shares or other forms of influence in a bank are adequate. Founders of banks need to provide information to the CBI in the context of the licensing process. Persons acting directly or indirectly or in concert with other persons who wish to acquire a holding of 10 percent or more in a bank, shall obtain prior approval of the CBI. The CBI will assess the expected effects of the acquisition on the financial soundness of the bank. Increases in the size of a holding to exceed a threshold of 20, 33, or 50 percent shall be notified to the CBI 30 days in advance. Also the bank itself shall inform the CBI of such changes in ownership. Moreover, mergers and substantial purchase and assumption transactions are subject to CBI approval.

Acquisitions: The rule that Iraqi banks are permitted to invest in non-bank or non-financial equities, without prior CBI approval, provided that the acquired stocks do not exceed 20 percent of the bank’s capital, needs tightening. The

15. See Organizing Regulations for Awarding Licenses to Banks and Non-bank Financial Establishments, Part 1, License Awarding to Local Banks, Phase 1, and 5th indent.
threshold of 20 percent below which no permission is required, is too high. The ability of Iraqi banks to acquire equity in other companies makes it even more urgent to introduce rules on consolidation of accounts and supervision on a consolidated basis.

3. Regulation and Prudential Requirements

In January 2011 a new series of prudential regulations\textsuperscript{16} was issued, providing generally workable basic rules on many of the main areas of prudential regulation, although refinements are needed, and enforcement seems to be weak, with large banks fundamentally ignoring key prudential standards.

The definition of capital now seems to approximate more closely the Basel I definition, although revaluation reserves are still included in Tier 1 capital, which is not in conformity with the Basel definition. A significant general problem with regard to any capital calculation are the non-IFRS compliant accounting standards used in Iraq, consequently uncertain capital values, and the uncertainty about the rigor of loan classification and provisioning by banks, in particular the large state owned banks.

The CBI has set a minimum risk weighted capital adequacy ratio of 12 percent. The CBI also intends to increase the absolute capital requirements even further by 2013, to encourage concentration of the banking sector, and to provide a larger buffer against the high degree of risk in the Iraqi financial system. However, given the limited opportunities for safe lending, it also raises the question how banks can safely gain a return on these increased capital investments.

The liquidity regulations stipulate a minimum ratio between assets and liabilities maturing within a week, which has been set by the CBI at 30 percent. Banks are required to report their one-month liquidity forecasts to the CBI on a daily basis.

The regulation on loan classification and provisioning appropriately combines quantitative criteria, in terms of time overdue, but also qualitative criteria. The regulation distinguishes five categories: “good”, requiring no provisions, “average”: overdue more than 30, but less than 90 days, and other criteria, also requiring no provisions; “below average”, overdue more than 90 but less than 180 days, requiring 20 percent provisions; “doubtful”, requiring a provision of 50 percent, and “bad”, requiring a 100 percent provision.

The CBI states that it has authority to override the decisions taken by the banks with regard to the classification of credits, while this may be the practice, the text

\textsuperscript{16} Regulations issued addressed licensing of banks and non-bank financial institutions, voluntary liquidation, mergers and acquisitions, credit classification and provisioning, large exposures, lending to connected parties, credit practices, investments by banks in Iraq and abroad, investments in Iraqi banks, capital adequacy, liquidity, liquidity risk management, operational risk management, market risk, general risk management, interest rate risk management, foreign exchange positions, internal audit, governance, internal control, and disclosure.
of neither the new nor the old regulation confirms this. It would be advisable to include this discretionary power explicitly in the regulation. Moreover, the zero provisioning for “average” loans does not seem justified, given the nature of the criteria for this classification, including unclear financial statements, defective management, and requests to restructure the loan.

Large exposure rules are conservative, but weakly enforced. Large exposures are defined as exposures between 10 and 15 percent of the bank’s capital, for which CBI permission is required, and exposures over 15 percent of the bank’s regulatory capital are presumably prohibited altogether, although the text of the regulation is not clear on this point. The total of large exposures may not exceed 400 percent of the bank’s capital.

The Board of a bank as well as the CBI must give permission for connected lending, defined as credit to related companies, relatives or key officials in the bank. These credits may not exceed 5 percent of capital, with the aggregate total limited to 15 percent of capital. Banks are required to report connected lending to the CBI.

4. Supervisory Approach, Reporting and Supervisory Practices

Prudential reporting and off-site analysis: Although the powers to collect information seem adequate, the processing of these data seems ineffective, given the extended lag times needed by the CBI to produce up to date and consistent capital adequacy figures for the banks. Moreover the risk that banks submit inconsistent and inaccurate data is increased due to the lack of a chart of accounts necessary to produce IFRS consistent data. Article 40 of the Banking Law states that the CBI has the authority to require banks and their subsidiaries to provide all such information as the CBI may request. At its request, banks shall provide the CBI with such information or data that reflect the risk position of banks. Each bank shall furnish the CBI at relevant intervals (i.e. quarterly) statements showing assets and liabilities, foreign currency exposures, reserve position, liquid assets, large exposures, and credit to related persons. Also information shall be provided on deposits, credit lines, credit plans, and off balance sheet commitments. Banks are required to submit annually their balance sheets and income statements.

The Banking Supervision Department has a Bureau for Studies and Research, which performs the off-site analysis function. Moreover the CBI has a special bureau for the collection of prudential returns, which also independently flags discrepancies and contacts the banks for clarification.

The CBI has also issued guidelines for the classification of banks in the CAMELS system: “Approved Controls for Assessing Private Banks. A relatively high level of vigilance is required for the 3-rated banks in the current environment, the 4 rated banks (two) are under conservatorship, and the 5-rated bank is a candidate for takeover by a strategic partner. However, it is alleged by senior officials at
the CBI as well as market observers that CAMELS ratings can be subject to undue influence by banks, which implies potential governance problems.

On-site inspections: The on-site inspection system seems appropriately organized, and inspections are well prepared, although follow-up on recommendations made on the basis of the inspection seems weak. Banks are inspected once per year, according to an annual inspection plan. On average, banks are inspected annually. A Terms of Reference for the inspection is prepared, taking into account known strengths and weaknesses, past off-site and inspection reports, and e.g. NPL-data. A letter is sent to the bank by the CBI to announce the inspection, communicating the names of the inspection team. The topics of the inspection are not mentioned in the letter.

The CBI has recently issued a Manual for Effective Banking Supervision, which provides more detailed guidelines for on-site inspections.

Due to the constraints mentioned above, the team was unable to obtain documented evidence of CBI follow up to verify banks’ compliance with corrective action mandated by the CBI. The bank has 30 days to respond to the draft inspection report, after which the CBI finalizes it. The head of the Banking Supervision Department subsequently sends a letter to the bank, instructing it to correct any adverse findings. The mission could not ascertain how the CBI follows up on how banks actually implement the corrections mandated by the CBI.

5. Accounting, Audit, Internal Audit/Controls, Disclosure

Accounting. International Financial Reporting Standards (IFRS) are not implemented by banks in Iraq, and there does not seem to be a chart of accounts to provide guidance how to compile the figures that are entered into the financial statements. Significant differences exist between IFRS and Iraqi accounting standards, such as the lack of a requirement to consolidate accounts (although Article 43(1) Banking Law requires banks to consolidate financial statements). Furthermore, there are no guidelines for the valuation of financial instruments, e.g. mark-to-market requirements. No clear guidance exists on revaluation of fixed assets.

However, the CBI has requested banks to start preparing parallel accounts, one according to Iraqi accounting standards and another according to IFRS. External auditors of banks are required to report significant issues to the CBI, including issues of safety and soundness of the bank.

Accountancy training is well structured, but the availability of accountants and auditors sufficiently qualified to work in banks is limited. A Commission of Supervision of the Accounting Profession oversees the quality of the accounting profession.

Audit: The tasks of a bank’s external auditor include helping to maintain proper accounting systems, financial control and risk management systems,
the preparation of an audit report for the Board and an opinion on the annual statements. The auditor is also required to comment on the adequacy and performance of management, report on the loan classification and provisioning system, as well as on any deficiencies in provisioning.

Internal audit: Article 24 Banking Law requires banks to form an Audit Committee. Banks seem to be required by regulation to have an internal audit unit, charged inter alia with oversight over connected lending, although the basis for the regulation in the law is not clear. The internal audit unit may communicate directly with any staff member of the bank and with the Board. The regulation also describes the role of a compliance officer in the bank.

Disclosures: Extensive disclosures are required to shareholders, stakeholders (undefined in the regulation) and customers of the bank, and banks’ audited financial statements must be published in two general newspapers. Banks’ financial statements may only be published after approval of the CBI.

6. Abuse of Financial Services

Notwithstanding the existence of important elements of a legal, regulatory and institutional Anti Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework, external observers note that the implementation of the AML/CFT framework in Iraq is extremely weak. Article 4(2) of the Law on the Central Bank of Iraq stipulates that the CBI is authorized to take any action it considers necessary to counter money laundering and the financing of terrorism. External auditors need to certify whether or not adequate measures have been taken by banks to prevent money laundering or the financing of terrorism. Money laundering-sensitive operations such as money transfer offices and exchange bureaus are also under the supervision of the CBI. Banks have an obligation to report suspicious transactions, but no typology of suspicious transactions is available. Reporting forms for suspicious transactions and large cash transactions are in place.

The anti-money laundering and anti-financing of terrorism framework is laid down in the Anti-Money Laundering Act of 2004. Currently, a new law is being drafted. According to Article 12 (2) of the Anti-Money Laundering Act of 2004, the Money Laundering Reporting Office shall be staffed and funded separately from the CBI, although it is administratively located under the CBI. In the new draft law, which has not yet been adopted, the new draft law states in Article 6 that the CBI shall establish the Anti-Money Laundering Bureau, headed by a General Director (or higher). The CBI and MLRO are authorized to exchange information with domestic and foreign agencies involved in Iraq in AML/CFT. Banks are required to apply know-your-customer practices and retain records of customers’ identities, as well as maintain transaction records for at least seven years. Banks must match customer information against a list of suspicious persons maintained by the CBI.
An FATF-MENA AML/CFT assessment has been tentatively scheduled for 2012-2013. Much work will still need to be done, in particular in implementation, to achieve a reasonable level of compliance by Iraq.

7. Corrective and Remedial Powers of the CBI

Although the CBI has an adequate range of options for enforcement action and penalties against breaches of prudential standards and the unsafe and/or unsound conduct of banking business, enforcement is considered weak. The CBI may send written warnings to a bank, give orders, request the bank to submit a program of corrective action, cease and desist orders, impose restrictions on certain credits, require the placing of deposits with the CBI, and/or request that the CEO or Board Chairman personally take responsibility for the implementation of remedial action. The CBI may also request the suspension of any manager, or remove the chairman or Board members, dissolve the Board and appoint a conservator, impose a penalty, or revoke the bank’s license. The CBI also has special rapid response “Urgent Action” teams which can be deployed for periods of one or two weeks.

The CBI may apply discretion to appoint a conservator when capital has declined to below 75 percent of the minimum level. It is obliged to appoint a conservator when it determines that capital of the bank has decreased below 50 percent, which represents a form of prompt corrective action. Forced liquidation is required when the CBI decides that capital has declined to below 25 percent of the minimum. The CBI may impose a moratorium with regard to a bank including a ban on taking new deposits. The conservator shall attempt to rehabilitate the bank if it is considered systemically important by the Minister of Finance. Currently, two banks are under conservatorship, and one bank is negotiating a take-over by a strategic partner, under CBI oversight.

The Law on the Central Bank of Iraq provides for the establishment and functioning of a Financial Services Tribunal. This court is responsible for conducting the bankruptcy of banks, according to the rules set out in the Law on the Central Bank of Iraq and the BL.

8. Consolidated Supervision

Although the law and regulations require consolidation of accounts and consolidated reporting in several places, the counterparts of the mission stated that there are no rules under the Iraqi accounting system on consolidation of accounts. This needs to be remedied as soon as possible, in the context of the implementation of IFRS.

9. Home-host Relations

Although the CBI contacts home supervisors in the context of the licensing of foreign institutions, through ad-hoc contacts via e-mail, letters and/or information
packages, there is no system of formal MOUs or other institutionalized contacts. Currently, six foreign banks have establishments in Iraq, either through joint ventures, branches or subsidiaries.

C. Risk Management

Banking risk management is considered to be one of the most important topics in the banking industry all over the world, especially after the global financial crisis.

1. The CBI Regulations

In response to the increased risk awareness resulting from the global crisis, the CBI revised its regulations, and issued a revised set in January, 2011. The CBI’s new regulations include one chapter regarding risk management in banks (Chapter 21) which deals with the principles of risk management and discusses them briefly. These regulations cover the following areas:

- Credit risk management;
- Interest rate risk management;
- Liquidity risk management and
- Operational risk management.

Although there has been some improvement in the CBI’s regulations of January 2011, the regulations on prudential standards require further review to establish whether or not they fully meet international standards or not, through a rigorous assessment on the basis of the Basel Core Principles and the 2006 Methodology.

2. Implementation of Risk Management

Most Iraqi banks do not implement sound risk management principles, partly due to lack of organizational as well as IT resources. The Iraqi banks and the CBI concentrate mainly on credit risk management, and the implementation of risk management in banks is an area of weakness.

Regulations need further refinement to bring them into full compliance with international standards, even though the current version is workable. Moreover, banks do not have adequate staff with risk management expertise. The new market risk prudential regulations covering interest rate risk, foreign exchange risk, equity risk and commodity are broadly consistent with international standards. However, the new regulations do not address the actual management of equity risk and commodity risk. The regulations on liquidity risk management, based on the principle of maturity gap analysis, conform broadly to the international standards. The CBI’s regulations on operational risk are based on Basel Committee’s document entitled “Sound Practices for the Management and Supervision of Operational Risk”.

Improvements have been made in the regulations regarding risk management, and the basic elements for banking supervision are in place, provided the CBI implements them vigorously. Nevertheless, a full and detailed review, based on a well-prepared self-assessment to assess consistency with international standards is recommended, in order to identify where amendments and additions are needed.

D. Legal Framework for Islamic Banking

The CBI is preparing a draft Islamic Banking Law to be issued in the near future. On the basis of this law, the CBI will be authorized to issue a complete set of laws and regulations applicable to Islamic banks, with the objective of maintaining the safety and soundness of both Islamic banks and the banking system as a whole.

This draft consists of 17 articles that deal with the nature, characteristics and credit forms of the Islamic banks as well as the accounting treatment for each credit form. These forms of Islamic credit are Murabaha (Profit-sharing); Musharakah (joint ventures); Mudarabah (Financing); Ijara (Renting); Istisnaa (Industrial - Financing); and Assets and Liquidity Management.

The draft law also determines which activities are permissible for Islamic banks and which are not permissible. It is therefore important than banks have a Sharia Committee which oversees that the Islamic bank’s activities are consistent with (Sharia) Islamic rules.

Currently, Islamic banks in Iraq must adhere to the Banking Law No. 94, of 2004 and the internal instructions of Islamic banking, issued in 2006. Pending new regulations specific for Islamic banking, based on the new Islamic banking law, any regulations issued by the CBI should be approved by the Shura Council. As a law on Islamic banking was not in place, the Shura Council did not approve any of the CBI’s regulations concerning Islamic banking activities.

Islamic banks are allowed to practice banking activities that are included in Article No. (27) Of the Banking Law. Moreover, they are allowed to use riba (interest rate), finance, and investment activities. Their activities are funded through the self-funding table operations. They may also invest funds of clients who wish to invest in other products in Islamic Banks.

A key tenet of Islamic banking is that clients are considered to take part in investment risk, in proportion to their account balance and duration of balance, and to bear their share of losses. The contract between the bank and the client may be terminated if the bank is proven negligent or the client has willfully defaulted. Parties may also decide to terminate the contract by common consent. The activities should then be terminated and any results (gain or loss) from the contract should be shared between the client and the bank.
An Islamic bank may practice any of the following activities, after obtaining CBI approval:

- Non-riba (interest rate) banking activities in all its forms, with clients in Iraq or abroad.
- Participation in industrialization, economic development and reconstruction projects as specified in the license granted by the CBI according to the Companies Act.
- According to the procedures for the establishment and capitalization of both limited and incorporated companies under the Companies Act.

An Islamic Bank should have a Sharia Supervision Board, consisting of at least five, but no more than seven members, to oversee the bank’s compliance with the Sharia law. Decisions of this Board are binding on the bank.

In particular, the Islamic Supervision Board shall perform the following functions:

- Monitoring the Islamic Bank’s activities in terms of its compliance to the Sharia rules.
- Delivering opinions on the Sharia-compliance of the conditions of the bank’s products and activities.
- Considering any matters assigned to it according to the instructions of the CBI.