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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED

**FIRST PROGRAMMATIC FISCAL SUSTAINABILITY
DEVELOPMENT POLICY LOAN**

IN THE AMOUNT OF US\$250 MILLION

TO

THE REPUBLIC OF IRAQ

February 12, 2010

**Social and Economic Development Department
Middle East and North Africa Region**

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CURRENCY AND EQUIVALENTS
(Exchange Rate as of February 10, 2010)
Currency Unit = Iraqi Dinar (ID)
US\$1 = ID1165.1

FISCAL YEAR
January 1 – December 31

ABBREVIATION AND ACRONYMS

AAA	Analytic and Advisory Activities	MoF	Ministry of Finance
BSA	Board of Supreme Audit	MOLSA	Ministry of Labor and Social Affairs
CBI	Central Bank of Iraq	NBF	National Board of Pensions
COA	Chart of Accounts	NDS	National Development Strategy
CoR	Council of Representatives	NPL	Non-Performing Loan
CPIA	Country Policy and Institutional Assessment	NPV	Net Present Value
DFI	Development Fund for Iraq	OP	Operational Policy
DPL	Development Policy Loan	PDS	Public Distribution System
EG II	Second Economic Government Program	PEFA	Public Expenditure and Financial Accountability
GDP	Gross Domestic Product	PFM	Public Financial Management
GFS	Government Finance Statistics	PRS	Poverty Reduction Strategy
ICI	International Compact for Iraq	PRSHC	High Committee for Poverty Reduction
ID	Iraqi Dinar	ROC	Restructuring Oversight Committee
IEG	Independent Evaluation Group	RTGS	Real Time Gross Settlement
IFC	International Finance Corporation	SBA	Stand-By Arrangement
IFMIS	Integrated Financial Management System	SME	Small and Medium Enterprises
IHSES	Iraq Household Socio-Economic Survey	SOE	State-Owned Enterprises
IMF	International Monetary Fund	SOMO	State Oil Marketing Organization
ISBFF	Iraq Small Business and Finance Facility	SPF	State Pension Fund
ISN	Interim Strategy Note	SSN	Social Safety Net
ITF	Iraq Trust Fund	TA	Technical Assistance
MENA	Middle East and North Africa	UNHCR	United Nations High Commissioner for Refugees
		USAID	United States Agency for International Development

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REPUBLIC OF IRAQ
FIRST PROGRAMMATIC FISCAL SUSTAINABILITY DEVELOPMENT POLICY LOAN

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LOAN AND PROGRAM SUMMARY

REPUBLIC OF IRAQ FIRST PROGRAMMATIC FISCAL SUSTAINABILITY DEVELOPMENT POLICY LOAN

Borrower	Republic of Iraq
Implementing Agency	Ministry of Finance
Financing Data	IBRD Loan Amount : US\$250 million. The loan will be denominated in US dollars at a fixed spread with a total repayment term including grace period of 15 years (with a grace period of 4.5 years). The Front-End Fee would be financed out of the loan proceeds (capitalized).
Operation Type	First loan of a series of two programmatic DPLs.
Main Policy Areas	This Development Policy Loan will provide support for: (i) strengthening budget management and prioritization; (ii) reforming the financial sector; and (iii) improving the efficiency of the social protection system.
Prior Actions	<p>Strengthening Budget Management and Prioritization</p> <ul style="list-style-type: none"> • The Ministry of Finance has adopted a framework for medium term budget strategy reflecting Government policy priorities and medium term macroeconomic and fiscal projections. • The National Poverty Reduction Strategy, which outlines public spending priorities in the social sectors, has been adopted by the Council of Ministers. • The Shura Council has completed the review of the draft of the Procurement Law, to be submitted to the Council of Ministers. • The Ministry of Finance has issued a decree establishing a High Level Committee to develop the Manual for implementing the Chart of Accounts. <p>Reforming the Financial Sector</p> <ul style="list-style-type: none"> • Settlement of at least 20 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007. • The Restructuring Oversight Committee (ROC) has endorsed the Banking Sector Reform Strategy and the Action Plan for the operational and institutional restructuring of the two state-owned commercial banks—Rafidain Bank and Rasheed Bank. • The Central Bank of Iraq (CBI) has approved its new organizational chart and a detailed program for capacity building in banking regulation and supervision. • CBI has introduced a real time gross settlement (RTGS) payments system complying with international standards. <p>Improving the Efficiency of the Social Protection System</p> <ul style="list-style-type: none"> • The Council of Ministers Secretariat has established a High Committee mandated to propose a time-bound action plan for rationalization of the Public Distribution System (PDS).

	<ul style="list-style-type: none"> • The Council of Ministers has endorsed a policy of reforming the current Social Safety Net through improved targeting methods. • The management and governance structure of the State Pension Fund (SPF), has been put in place through (i) approval of the executive regulations and by-laws of the SPF by Council of Ministers; and (ii) appointment of the General Manager of the SPF by the Prime Minister; and (iii) appointment of the Board of Directors of the SPF by the Minister of Finance.
Key Outcome Indicators (by March 2011)	<p>This DPL reflects some of the key achievements of Iraq’s reform agenda as of February 2010. The prior actions under this DPL are expected to generate the following outcomes by the time this loan closes:</p> <p>I. Strengthening budget management and prioritization:</p> <ul style="list-style-type: none"> • Continued strengthening of the link between policy and budget as revealed by pilot medium term financial planning in two ministries • The first annual PRS monitoring report completed by the High Committee for Poverty Reduction evaluates alignment between priorities and budget allocations. • Adequate implementation of the new legal framework for public procurement, including: (i) issuance by Council of Ministers of the Regulations of the new Public Procurement Law; (ii) Public Procurement Regulatory Authority (PPRA) established by a Decree of Council of Ministers and full operational ; (iii) issuance by MoPDC of the Standard Bidding Documents (based on the new Public Procurement Law and Regulations; and (iv) ministerial procurement function organized in accordance with the law and the regulations. • Timely availability of fiscal accounts for the execution of the 2011 budget; accounts published no later than 60 days after the end of the month. • 2011 Budget classification and Chart of Accounts are aligned. <p>II. Reforming the financial sector:</p> <ul style="list-style-type: none"> • Settlement of at least 40 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007, as well as improvement in the provisioning levels. • Rafidain and Rasheed banks diversify their activities beyond deposit taking and payment transactions, and play a more active role in financial intermediation. • Improvement in the functioning of the two state-owned commercial banks, evident in the increase in loan-to-GDP ratios from 4% in June 2006 to 6% in October 2010. • The banking system is largely adhering to the Basel Core Principles for Effective Banking Supervision. • Reduction in processing time of government checks and collections from 25 days to 10 days. <p>III. Improving the efficiency of the social protection system:</p> <ul style="list-style-type: none"> ▪ Rationalization of the Public Distribution System (PDS) has been initiated through elimination of high income civil servants from PDS eligibility, as well as other high income groups as determined by the Government. ▪ A public information campaign has been launched to announce PDS

	<p>targeting objectives and explain the process and timeline for this transition</p> <ul style="list-style-type: none"> • Piloting of Social safety net with new and improved targeting mechanism under way. • Key provisions of the new Unified Pension Law are implemented; including the discontinuation of labor force segmentation across public and private sectors.
<p>Program Development Objective(s) and Contribution to CAS</p>	<p>The objective of the proposed DPL is to mitigate the impact of the current fiscal crisis on Iraq’s economy and to support its medium-term economic reform program, thereby helping the country improve fiscal sustainability and reducing its fiscal and socio-economic vulnerability to sudden drops in oil revenues.</p> <p>More specifically, the project supports the following objectives:</p> <ul style="list-style-type: none"> • <i>Helping bridge the financing gap created by lower oil prices;</i> • <i>Strengthening budget management and prioritization to enable more efficient and effective use of Iraq’s own resources;</i> • <i>Strengthening the financial sector;</i> • <i>Helping to cushion the social impact of lower oil revenues by reforming social safety nets and the pensions system.</i> <p>The common theme of improving Iraq’s fiscal sustainability prospects brings these specific goals together. First, strengthening budget management and prioritization is critical to ensure aggregate fiscal discipline and reduce waste and unproductive expenditures. Second, financial sector reform will help reduce the direct budgetary burden of state-owned banks as well as the contingent liability they represent. Third, a social protection system can only be truly efficient if it is fiscally sustainable, which can be achieved through the rationalization of the costly and large Public Distribution System and through pension reform.</p> <p>This DPL is fully consistent with the Interim Strategy Note FY09-11 presented to the Board of Executive Directors in March 2009 and will help implement and achieve ISN objectives. The ISN aims to: (i) support ongoing reconstruction and socio-economic recovery; (ii) improve governance and the management of public resources; and (iii) support policies and institutions that promote broad-based, private sector-led growth. The three DPL pillars are linked as follows to the ISN themes: Social safety nets are part of the first theme of the ISN; budget management and prioritization is at the core of the second; and financial sector reform is a key component of the third. In all three areas there are ongoing Bank-supported investment and technical assistance operations being implemented in Iraq as well as past, current or planned AAA work.</p>
<p>Risks and Risk Mitigation</p>	<p>The Program faces significant risks, which include:</p> <p><i>Political and economic performance risks.</i> The ability of the Bank Group to engage with Iraq would become constrained by a reversal of recent, hard-won security gains. Related to that, a deterioration in the political environment either in Iraq or in the Region would also affect the Bank’s ability to implement its assistance program. The DPL could also be affected by risks related to the Government’s commitment to an ambitious reform program at this time. In particular, the design of a robust program acceptable to the Iraqi authorities might be challenging in an electoral year</p>

and during a time where oil prices have started to rise anew. Likewise, a new Government post elections may not agree to implement the same program. Given these political uncertainties, the operation has been designed as a single tranche DPL as part of a programmatic series of two DPLs. This DPL is underpinned by a reform agenda already adopted by the current Government. In addition, this reform program is being implemented with support through ongoing technical assistance programs by the Bank, IMF and other donors. It has also been designed to be realistic, yet consist of important reforms and milestones, complementing existing Government reforms supported by ongoing TA activities, each with their own risk mitigation measures, and opening the door for the Bank to engage with the Government in the medium to long term on critical issues to improve Iraq's fiscal sustainability. The programmatic approach of this DPL will also help mitigate the risk of relevance and ownership across Governments.

Oil revenue volatility risks. Iraq has been subject to major fluctuations in its oil revenues, reflecting its extreme dependence on crude oil exports. This makes it extremely challenging to conduct fiscal policy with a medium-term orientation, while maintaining adequate levels of public spending. To help mitigate this risk, this operation aims to support reforms that would help reduce Iraq's fiscal and socio-economic vulnerability to abrupt changes in oil prices and revenues. In addition, the Bank will conduct analytical work and provide technical assistance on oil revenue management issues for Iraq, including assessing the feasibility of special fiscal institutions such as oil funds.

Security risks. As in many conflict-affected countries, a deterioration of the security situation constitutes a large source of risk for the operation. Continuing security incidents, for example, the attacks in August 2009 and December 2009 against several Government ministries are a manifestation of such risks. The capacity of the Iraqi Government and whether the international community continues to support security will be determinants of the extent of risk that persists. However, the financing from this DPL, and the fact that it is part of a substantial international effort that includes IMF resources, would provide the external financing needed to fill the budget gap. This would help the Government maintain its recurrent and investment spending to keep the system going while still providing essential services to the population in a fragile and volatile environment, which may help to mitigate some domestic security risks. Support through this DPL is the Bank's contribution to a larger package that will help Iraq continue its physical and institutional reconstruction and thereby reduce destabilizing factors and foster a more secure environment.

Fiduciary risks. As indicated in the section on fiduciary assessment, financial controls in Iraq are weak and the operation's fiduciary risk is high. Weaknesses in Iraq's institutional environment increase the exposure of the Bank's resources to fiduciary problems. The fiduciary risks in this operation cannot be mitigated. In the longer term, the Bank is supporting the Iraqi Government in strengthening its public financial management system through PFM Reform Project, which will help strengthen the Government's fiduciary environment for budget support by supporting improved allocation, execution, transparency and accountability in the mobilization and use of all public resources. Furthermore, the Bank has conducted a fiduciary assessment to accompany this operation which has identified weaknesses and areas for improvement.

	<p><i>Program Risks.</i> The new Government may not request the second DPL if the financing needs are reduced. While the new Government may be committed to the general principles of the DPL reform program, it may adopt a different set of priorities, for example, by placing a greater emphasis on some components, thus requiring changes in the triggers for the second DPL. To mitigate the risks, the programmatic approach chosen for this operation offers greater flexibility than a tranching operation, and the indicative second DPL triggers are based on reforms that are already underway.</p> <p><i>Technical capacity risks.</i> Lack of technical capability among key Government agencies to implement the reform program present another source of risk. Companion technical assistance projects in each of the three pillars are designed to help build the requisite capacity.</p>
Operation ID	P119214

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
PROGRAM DOCUMENT FOR A
PROPOSED FIRST PROGRAMMATIC FISCAL SUSTAINABILITY DEVELOPMENT POLICY LOAN
TO THE REPUBLIC OF IRAQ

I. INTRODUCTION

- 1. This program document proposes a Fiscal Sustainability Development Policy Loan (DPL) in the amount of US\$250 million, which would be the first of a programmatic series of two DPLs totaling US\$500 million.** The objective of the proposed DPL is to mitigate the impact of the current fiscal crisis on Iraq's economy and to support its medium-term economic reform program, thereby helping the country improve fiscal sustainability and reducing its fiscal and socio-economic vulnerability to sudden drops in oil revenues.
- 2. Iraq is an oil-dependent economy that is emerging from years of conflict.** The complexity of Iraq's situation cannot be overstated. On the one hand, as the country recovers from conflict, its reconstruction and rehabilitation needs – both from an infrastructure and from an institutional standpoint – are immense. Iraq requires an appropriate level of public spending to meet its reconstruction needs, which ultimately helps maintain security and political stability. On the other hand, Iraq's excessive dependence on oil revenues makes it highly vulnerable to abrupt changes in international oil prices. Therefore, Iraq's main source of financing is considerably volatile and its revenue flows are largely unpredictable.
- 3. Iraq's vulnerability to external shocks became particularly manifest in 2008-9 when its fiscal position deteriorated significantly due to the sharp decline in oil prices starting in late 2008.** After holding fiscal surpluses in the order of 8.8 percent of GDP and 1.7 percent of GDP in 2007 and 2008 respectively, Iraq is projected to have an overall fiscal deficit of about 22.6 percent of GDP in 2009. A considerable financing gap – in the order of US\$4.9 billion – has emerged for the period 2009-2011. This gap will need to be filled through external financing.
- 4. Together with the new Stand-By Arrangement with the IMF, World Bank budget support will help sustain an adequate level of public expenditures in Iraq to strengthen the delivery of key public services and rebuild infrastructure.** Building on lessons from the experience of other post-conflict and fragile states, Iraq's public spending could be impacted by severe fiscal cuts that can undermine stability and security as insurgent groups could exploit the weaknesses of a State undergoing a fiscal crisis.
- 5. Through the financing it brings about, the proposed operation will help relieve immediate pressures on Iraq's budget.** Iraq's financing gap is projected to be most pronounced during 2010. Timely external financing is critical to ensure that essential expenditures – including investment spending – are maintained at an adequate level, which is particularly important given Iraq's already fragile context.
- 6. Through the reform program that underpins it, the proposed operation will help focus attention on key reforms critical to Iraq's longer-term development.** These reforms are reflected in a set of prior actions to be completed before the proposed operation becomes effective, as well as on triggers for the second DPL in this proposed series. These reforms focus on: (i) strengthening budget management and prioritization; (ii) reforming the financial sector; and (iii) improving the efficiency of the social protection system. They are consistent with the thematic areas of the Bank's Interim Strategy Note 2009-

2011 for Iraq. The prior actions focus largely on institutions and processes. This is because many of Iraq's institutions were rendered dysfunctional during the past thirty years of authoritarian rule followed by war. As a result, they need to be substantially modified to fit the needs of a modern democratic state.

7. The need to help improve Iraq's fiscal sustainability prospects also provides a common goal for the three selected reform areas. First, strengthening budget management and prioritization is critical to ensure aggregate fiscal discipline and reduce waste and unproductive expenditures. Second, financial sector reform will help reduce the direct budgetary burden of state-owned banks as well as the contingent liability they represent. Third, a social protection system can only be truly efficient if it is fiscally sustainable, which can be achieved through the rationalization of the costly and large Public Distribution System and through pension reform.

8. The three reform areas are supported by ongoing technical assistance by the Bank and other donors. In particular, companion Bank projects are under implementation in the areas of public financial management, banking sector reform, and social protection. These projects have been closely coordinated with the IMF and donors, including DFID, the European Commission, US Treasury and USAID. In addition, the proposed operation is closely coordinated with the Stand-by Arrangement operation expected to be presented to the Board of the IMF on in late February 2010. The Bank operation relies on the fiscal framework established in the SBA, while the SBA is complemented by the reforms envisaged in the Bank operation with respect to strengthening public financial management, the financial sector and social protection.

9. In addition to providing a timely response to Iraq's financing needs, the proposed schedule of the operation reflects the country's current political economy. This operation would provide the Bank an opportunity to launch a well-conceptualized dialogue with the new Government and support the continuation of policy reforms. To that end, it is vital to build on the commitment of the current Government, and to agree on a fiscal and structural reform program so that policy moves along desirable tracks in the period following the elections. Commitments made to international financing institutions will help lock in the appropriate reform measures. To ensure the commitment on the part of the Iraqi authorities, parliamentary approval of the 2010 Budget was essential to confirm the IMF and Bank assessment of Iraq's fiscal program and to proceed with the proposed budget support.

10. This DPL would add value to the portfolio of existing Bank operations in Iraq and help achieve the objectives laid out in the Bank's strategy to support Iraq. In particular, it brings together for the first time different elements of Bank assistance under a consolidated, coherent reform package; lays out prior actions and future reforms in areas not directly addressed in previous operations, such as the links between the Iraq's Poverty Reduction Strategy and the State Budget as well as the rationalization of the Public Distribution System; and helps accelerate policy decisions in a number of reform areas, thereby energizing the reform agenda and providing synergy with the implementation of the investment project portfolio.

II. COUNTRY CONTEXT

A. Recent Economic and Political Developments

11. The Republic of Iraq—with an estimated population of about 30 million—faces substantial development challenges. Chief among these is the need to build its infrastructure and institutions after a

tragic history of authoritarian rule followed by war and occupation, a task made difficult by the prospect of political instability and the excessive dependence on one commodity, crude oil, for its revenues.

12. Wars, sanctions and weak governance have contributed to a marked deterioration in Iraq's standards of living in recent years. For example, the infant mortality rate in Iraq is close to the rates in the MENA region's poorest countries, Djibouti and Yemen. Furthermore, school enrollment has declined over the past decades as a result of low quality of and low returns to education. Iraq's poverty headcount index is relatively high at 22.9 percent. However, with a poverty gap of only 4.5 percent, Iraq's poverty is shallow. This means that a relatively small amount of resources—through income growth or transfer mechanisms—could lift most of the poor above the poverty line.

13. Iraq's oil dependence is reflected by the fact that 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. Volatility of international oil prices means that Iraq's oil export revenues are highly volatile. Crude oil export revenues are projected to drop by about 40 percent between 2008 and 2009, in light of recent developments in international oil prices. In particular, Iraq's oil export price is expected to drop from an average of US\$91.5 per barrel in 2008 to a projected average of US\$55.6 per barrel in 2009.

14. Despite these obstacles, Iraq's macroeconomic performance over the past few years has been sound. After spiking at 65 percent in 2006, inflation has been kept at a moderate level. Notwithstanding sharp food price increases in the first half of 2008, inflation was contained at 6.8 percent by end 2008. This has allowed the Central Bank of Iraq to ease monetary policy by reducing the policy interest rate to 7 percent in recent months.

15. Iraq successfully concluded two Stand-By Arrangements (SBA) with the IMF in December 2007 and 2008. Implementation of the SBA program supported Iraq's macroeconomic stabilization process, leading to much lower levels of inflation and dollarization of the economy. Successful completion of the SBA triggered the release of the final tranche of the debt relief agreed with the Paris Club.

16. From a political perspective, the most important milestone for Iraq in the near term is the parliamentary elections, which are scheduled to take place on March 7, 2010. The March poll will elect new representatives in the Council of Representatives (CoR) as well as a new president and a new government. The new polling date represents a seven-week delay over the original date of January 16, 2010. The delay was caused by lack of agreement on some key issues, mainly over the number of seats allocated to Iraqi expatriates and minorities and which voters list to use for the governorate of Kirkuk (Tamim).

17. The elections are expected to be of significant importance and impact on the future of Iraqi politics. In particular, the electoral process can help address political differences without resorting to sectarian or ethnic conflict as in the recent past. These would be the first elections with Iraqi forces providing security over the entire country.

B. Macroeconomic Outlook

18. Iraq maintained macroeconomic stability and good economic performance in 2008. Real GDP growth in 2008 is estimated at 9.5 percent, while end-2008 inflation reached 6.8 percent, compared to 64.8 in 2006. The overall fiscal situation in 2008 was positive due to high oil revenues. Table 1 summarizes the macroeconomic outlook for Iraq. Total revenues totaled nearly US\$73 billion in 2008.

Execution of the investment spending allocation in 2008 (85 percent of overall investment budget) has increased compared to previous years, although delays were caused by the spate of bombings targeting Government buildings in the second half of 2009. Iraq's economy still relies heavily on the oil sector for its revenues and GDP remains highly volatile. Nominal GDP contracted by an estimated 25 percent in 2009 while real GDP expanded by 4.2 percent mainly in the non-oil sector (non-oil growth is estimated at 4 percent for 2009). Overall inflation fell by over 4 percent year-on-year.

19. Total Government expenditures increased considerably between 2007 and 2008, partly as a response to rising oil revenues at the time as well as security improvements. Total Government spending rose from about US\$42 billion to US\$71.5 billion between 2007 and 2008. This increase in spending reflects a number of factors, such as a commensurate increase in oil revenues during this period, a significant increase in the salary and pension bill (from US\$10.9 billion to US\$17.3 billion), and a more than doubling of investment expenditures (from US\$8.9 billion to US\$22.6 billion), reflecting the improved security situation and an enhanced capacity on the part of the Government to execute the capital budget.

20. Given Iraq's oil dependence and the volatility of oil revenues, macroeconomic variables expressed as a share of GDP need to be interpreted carefully. Because of the dominant role of the oil sector in Iraq's economy, nominal GDP is highly sensitive to changes in oil prices. For example, Iraq's nominal GDP is projected to drop from US\$86.5 billion in 2008 to US\$66 billion in 2009, before recovering somewhat to a projected US\$80 billion in 2010. Therefore, fluctuations in variables such as the public spending-to-GDP ratio to a large extent reflect changes in the denominator as opposed to changes in the numerator. In fact, between 2008 and 2009 total fiscal spending as a share of GDP is estimated to have risen from 82 percent to 99 percent, while in nominal terms it declined from US\$71.4 billion to US\$65.2 billion (see Table 2 and paragraph 23). On the other hand, oil revenues as a ratio to GDP are much more stable, as shown in Table 1.

Table 1. Iraq: Macroeconomic Outlook

	2006	2007	2008e	2009p	2010p	2011p	2012p
Economic growth and prices							
Nominal GDP (US\$ billion)	45.1	57.0	86.5	65.8	80.3	92.8	106.2
<i>of which Non-oil GDP (% of GDP)</i>	46.6	38.0	31.0	45.8	41.6	39.7	38.5
Real GDP (% change)	6.2	1.5	9.5	4.2	7.3	7.9	7.6
<i>of which Non-oil GDP (% change)</i>	7.5	-2.0	5.4	4.0	4.5	5.0	5.5
GDP per capita (US dollars)	1,568	1,926	2,845	2,108	2,505	2,826	3,156
Oil production (million bpd)	2.0	2.0	2.3	2.4	2.6	2.9	3.1
Oil exports (million bpd)	1.4	1.6	1.8	1.9	2.1	2.3	2.5
Consumer Price Index (% change)	64.8	4.7	6.8	-4.4	6.0	5.0	5.0
National Accounts							
			(percent of GDP)				
Gross domestic investment	15.4	19.8	28.1	28.1	31.5	28.7	27.6
Of which public	13.9	15.6	26.1	24.4	27.5	23.9	22.3
Gross domestic consumption	72.1	63.7	55.2	87.5	85.2	78.9	76.7
Of which general government	38.6	41.0	36.9	56.1	50.2	42.3	36.8
Gross national savings	30.8	32.5	43.2	8.7	10.5	23.3	26.5
Of which public	28.2	25.3	27.8	-2.6	7.7	17.3	25.7
Fiscal and oil sector accounts							
			(percent of GDP)				
Revenues and grants	80.7	75.2	84.3	76.5	75.4	74.7	73.5
of which oil revenues ¹	65.5	67.6	77.6	68.0	67.0	66.8	66.1
Expenditures	66.5	66.4	82.6	99.0	94.5	80.5	71.4
Operating expenditures	52.6	51.9	56.4	78.4	67.0	56.5	49.1
Capital expenditures	13.9	13.9	26.1	24.4	27.5	23.9	22.3
Overall fiscal balance (including grants)	14.2	8.8	1.7	-22.6	-19.1	-5.7	2.2
Balance of Payments							
			(percent of GDP, unless otherwise indicated)				
Current account balance	18.9	12.7	15.1	-19.4	-21.0	-5.5	-1.1
Trade balance	27.1	23.5	24.0	-2.9	-3.0	4.1	6.6
Merchandise exports	66.3	66.4	71.7	59.7	60.8	61.1	61.5
<i>of which oil (in percent of total exports)</i>	97.7	98.2	98.6	98.9	98.1	97.7	97.8
Merchandise imports	39.1	42.9	47.7	62.7	63.8	57.0	54.9
External Public Debt ⁽²⁾							
Estimated Debt Stock (US\$ billion)	99.0	103.1	95.6	90.2	33.8	34.7	35.0
<i>in percent of GDP</i>	220	181	110	137	42	37	33
<i>in percent of exports</i>	331	272	154	229	69	61	54
Memorandum Items							
Iraqi oil price (US\$ per barrel)	55.2	63.0	91.5	56.5	62.5	67.5	70.0
IMF Crude oil price forecast, average (US\$ per barrel) ³	..	..	97.0	62.0	76.0	82.0	84.8
<i>Differential between Iraqi oil price and IMF forecast</i>	..	..	..	-5.5	-13.5	-14.5	-14.8
Gross Reserves (US\$ billion)	20.0	31.5	50.2	44.3	44.0	43.7	43.8
<i>Gross reserves in months of imports</i>	9.3	7.7	11.9	8.5	8.1	7.4	6.9
Primary fiscal balance (in percent of GDP)	14.8	9.6	2.2	-21.7	-18.0	-4.4	3.8
Exchange rate, ID per US\$1 (period average)	1467	1255	1193	1170	..	..	..

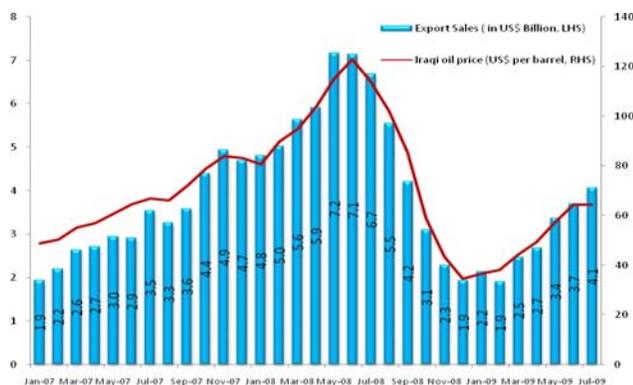
Source: Iraq authorities, IMF and World Bank staff estimates.

(1) including revenues of oil related public enterprises

(2) assumes a debt reduction in 2010 by Non-Paris Club creditors, comparable to the Paris Club Agreement

(3) APSP (average petroleum spot price) is a simple average of UK Brent, Dubai, and West Texas Intermediate spot prices reflecting world exports of light, medium, and heavy crude oil. Source IMF

21. Fiscal policy in Iraq is characterized by three main aspects that provide some cushion against sudden fluctuations in oil revenues: (i) a conservative budget oil price to guide estimates of the budget envelope; (ii) protection of expenditures from revenue volatility through development of borrowing instruments and through use of MTF; and (iii) use of fiscal buffers (DFI balances and Ministry of Finance balances in CBI) to reduce the expenditure impact of oil revenue volatility. There are no formal fiscal rules in place yet, but the Fund and the Bank are ready to engage in dialogue on fiscal rules in the medium term through Analytical and Advisory Work.



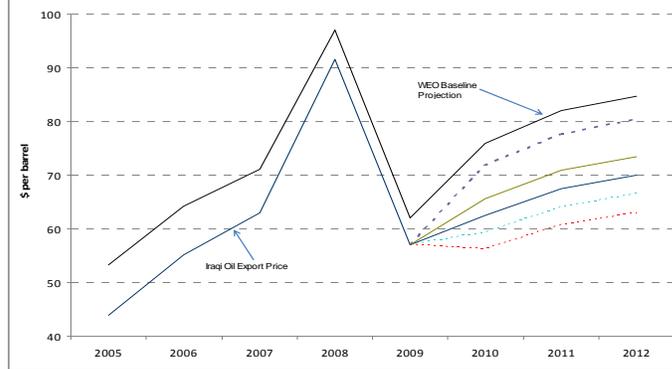
22. However, even these fiscal safeguards did not prevent Iraq's fiscal stance from deteriorating significantly with the decline in oil prices in the second half of 2008. After holding fiscal surpluses in the order of US\$5.5 billion and US\$1.5 billion in 2007 and 2008 respectively, Iraq is projected to have an

overall fiscal deficit of US\$15.3 billion in 2009, tapering off to US\$5.3 billion in 2010 as oil revenues start to recover. Preliminary sensitivity analysis – including downside and upside scenarios – illustrates the significant impact of changes in oil prices on Iraq’s revenues and fiscal stance (see Box 1).

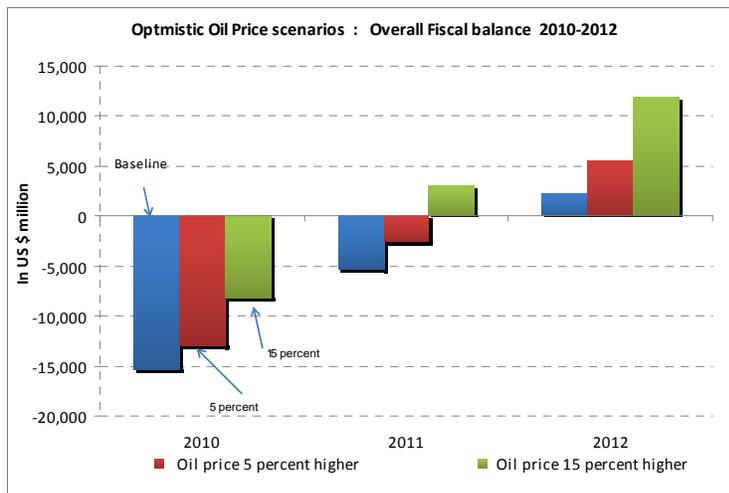
Box 1. Iraq: Crude oil price projections and sensitivity scenarios for the overall fiscal balance 2010-12

Under the most recent WEO baseline projection, the price of crude oil is expected to reach 76 \$/b for 2010. The 2010 budgeted Iraqi oil price is 62.5 \$/barrel. Under the baseline assumptions, a deficit of about US\$15 billion will arise in 2010 resulting in a US\$3.4 billion financing gap for that year.

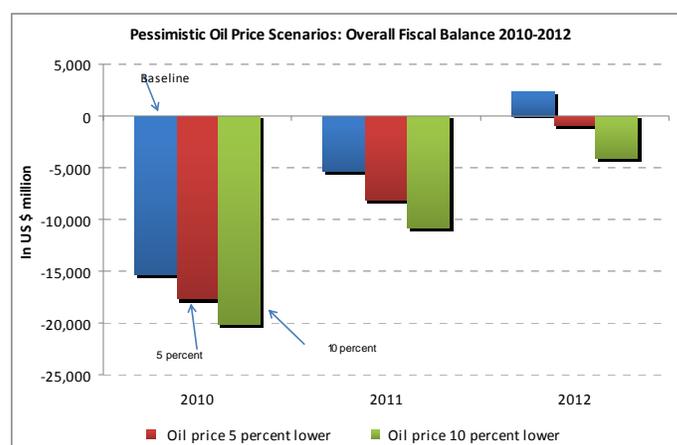
Figure 1. Crude oil price projection and alternative scenarios



Upside scenarios. If the Iraqi oil price is 15 percent higher than the baseline scenario (72 \$/b), the overall fiscal deficit is estimated to decrease to US\$8.1 billion for 2010 (47 percent less than the baseline deficit), assuming that projected total expenditures and non-oil fiscal revenues and grants remain unchanged for the period 2010-12. The projected financing gap would not materialize as DFI balances would increase. The overall fiscal balance would shift to a surplus of US\$11 billion by 2012 (see figure below).



Downside scenarios. If the Iraqi oil price is 5 percent lower than the baseline scenario (59.4 \$/b), a fiscal deficit of US\$ 17.7 billion would emerge (15 percent higher than the baseline projection) with a larger financing gap. The fiscal balance would remain in deficit for the whole period. See figure below.



23. **The Government's response going forward aims to contain current expenditures while protecting priority spending categories, in light of the country's reconstruction needs.** A sharp fiscal adjustment took place in 2009 with a reduction in total spending from US\$71.4 billion in 2008 to about US\$65 billion, mostly due to reduced capital spending. On the other hand, current expenditures are estimated to have increased by 4 percent between 2008 and 2009, mostly driven by additional spending on security. However, total expenditures over 2010-2012 are projected to stabilize around US\$75 billion. In particular, the Government aims to contain current spending by refraining from public sector wage increases, limiting public sector hiring, improving targeting of the Public Distribution System, reducing transfers to state-owned enterprises and preventing a resurgence of direct fuel price subsidies.

Table 2. Iraq: Government Finances: 2008-12

	2008 Est.	2009 Proj.	2010 H1	2010 H2	2010 Proj.	2011 Proj.	2012 Proj.
(In billions of U.S. dollars)							
Total revenues and grants	72.9	50.5	26.8	33.7	60.5	69.4	78.1
o/w Crude oil export revenues	62.0	39.0	22.5	25.4	47.9	55.4	63.9
Revenues from oil-related public enterprises	5.2	5.9			5.9	6.6	6.3
Tax revenues	1.1	1.1			1.0	1.4	1.6
Non tax revenues	2.2	2.5			4.3	4.8	5.4
Grants	2.4	2.1			1.4	1.2	0.9
Total expenditures	71.5	65.3	34.6	41.2	75.8	74.7	75.8
Current expenditures	48.8	51.6	26.9	26.9	53.8	52.5	52.1
Capital expenditures	22.6	16.1	7.7	14.3	22.1	22.2	23.7
Statistical discrepancy/returned LCs		-2.4			...	...	...
Balance	1.5	-14.8	-7.8	-7.5	-15.3	-5.3	2.3
<i>In percent of GDP</i>	1.7	-22.5			-19.1	-5.7	2.2
Financing	...	14.8	6.3	5.6	12.0	3.8	...
Use of DFI	...	0.3	5.8	1.6	7.4	0.0	...
Net external (incl. SDR allocation)	...	-0.3	1.5	1.1	2.6	0.8	...
MoF deposits with CBI	...	10.4	0.0	0.0	0.0	0.0	...
o/w use of SDR allocation	...	0.0	0.0	0.0	0.0	0.0	...
Other domestic bank financing	...	1.0	-1.0	0.0	-1.0	0.0	...
Treasury bills	...	3.4	0.0	3.0	3.0	3.0	...
Domestic arrears	...	...	-1.0	0.0	...	...	...
Financing gap	...	0.0	1.5	1.9	3.4	1.5	...
<i>Memorandum items:</i>						4.9	
Balance in DFI (excl. FMS)	10.3	10.0			2.6	2.6	...
MoF deposits with CBI (end of period)	11.2	0.8			0.8	0.8	...
WEO oil price (\$/bbl)	97.0	62.0			76.0	82.0	84.8
Iraqi oil export price (\$/bbl)	91.5	57.0			62.5	67.5	70.0
Crude oil exports (mmbpd)	1.80	1.87			2.10	2.25	2.50
GDP (in US\$ billion)	86.5	65.8			80.3	92.8	106.2

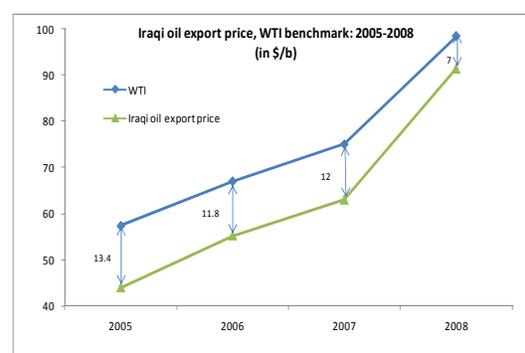
Sources: Iraqi authorities; and IMF staff estimates and projections.

24. **Preliminary IMF estimates indicate a financing gap in the order of US\$4.9 billion for Iraq over the period 2010-2011.** This financing gap estimate already takes into account projected reductions in the

balance of the Development Fund for Iraq (DFI) (from US\$10 billion in 2009 to US\$2.6 billion in 2010) as well as in Government deposits with CBI (from US\$11.5 billion in 2008 to US\$0.8 billion in 2010), in addition to a substantial issuance of treasury bills (in the order of US\$9 billion over 2009-2011). Reflecting the country's current fiscal situation, the Iraqi authorities have expressed interest in a 24-month US\$3.8 billion successor SBA, representing 200 percent of Iraq's quota. The IMF conducted discussions with the Iraqi authorities on a successor SBA in two missions (July and September-October 2009), joined by Bank staff.

25. The fiscal program agreed with the IMF calls for balances to be left in the DFI and the CBI (totaling \$3.4 billion at the end of 2010). These are meant to be precautionary buffers to absorb unforeseen shocks and are set at a level sufficient to cover three months of public sector wages and salaries. Furthermore, Iraq has limited access to international and domestic commercial debt markets and its spreads remain considerably higher than in other MENA countries. Therefore, it is prudent to maintain precautionary balances in light of the volatility of Iraq's oil revenues.

26. The Iraqi crude oil export price is subject to a discount reflecting transportation costs and quality factors specific to Iraqi oil. Iraq's oil export price is on average lower than average world crude oil prices because of this differential. Iraq's official selling price set by SOMO is currently benchmarked against the WTI Cushing for US sales, the Oman/Dubai average for exports to Asia and the North Sea for exports to Europe¹. Over the 2005-2008 period, the Iraqi oil price averaged at about US\$11 below the WTI benchmark. The Basra crude, Iraq's main crude export, sells at a higher discount than the Kirkuk crude.



27. An additional fluctuation risk discount is used to determine the budgetary oil prices adopted by the Iraqi authorities to forecast fiscal revenues. The resulting oil price is calculated as the difference between the average petroleum spot price (APSP)², the quality differential described above, and an additional fluctuation risk discount (set at 10 percent) to take into account Iraq's extreme dependence on oil revenues.³ This formula underlies the oil price assumptions used in the financing gap calculations. This is consistent with the principle of adopting a conservative budgetary oil price, and is in line with current practice in a number of oil-exporting countries⁴. While oil prices are expected to recover

¹ These were the benchmarks used by SOMO as of December 2009. In January 2010, SOMO announced it is considering shifting its WTI benchmark to the Argus crude benchmark. The rationale for SOMO is twofold: (i) Iraqi crude oil exports have shifted from the US market to Asia over the years. According to official figures, 54 percent of Iraq's crude was shipped to the US in 2006 to currently 54 percent of Iraqi crude going to Asia; (ii) the volatility of the WTI benchmark led to wide fluctuations in the differential between the Iraqi oil price and the WTI and a loss of income for Iraq. These fluctuations were mainly related to US domestic conditions at the WTI delivery point and did not reflect the international market.

² That is, a simple average of UK Brent, Dubai and West Texas Intermediate spot prices for world exports of light, medium and heavy crude oil.

³ The formula used in the calculation of the Iraqi budget oil price in Table 2 is: APSP – Quality Differential (at \$7 pb) – Fluctuation Risk Factor (at 10%)

⁴ "The use of conservative budget oil prices reflects prudential considerations and/or political economy factors. Such oil price assumptions are viewed as a prudent way to reduce the risk of a large deficit or fiscal adjustment in the event of an unanticipated decline in oil revenue. Governments have also sought to use low budget oil prices to contain spending pressures". In Ossowski,

slowly from their low levels of 2008 and 2009, given their volatility and uncertainty, it is more prudent from a fiscal standpoint to stress downside rather than upside risks. Gap assumptions are also based on estimated export volumes for the next three years from the Southern and Northern fields. Crude exports are expected to average 2.1 mbpd over 2009-2010. Given the fragility of the infrastructure in the oil sector and a potential reduction in northern field exports considering the political disputes around the status of Kirkuk, oil export volumes might also be lower than projected⁵.

28. On the monetary policy front, due to reduced inflationary pressures, the CBI has loosened its stance since 2008. The CBI started to appreciate the dinar in November 2006 to counter dollarization and reduce inflation. More recently, it has shifted from a policy of gradually appreciating the exchange rate one of maintaining a stable rate vis-à-vis the US dollar. In addition, the CBI reduced its policy interest rate from 15 percent to 14 percent in January 2009 and to 7 percent in June as price pressures were restrained and to eventually encourage banks to lend money to promote private sector growth.

29. Preliminary analysis by the IMF suggests that the real effective exchange rate is broadly in line with fundamentals. The recent fall in oil prices suggest that the Iraqi Dinar might be slightly overvalued, but there seems to be no significant deviation from the equilibrium real effective exchange rate. Relatively low levels of inflation also suggest that overvaluation risks brought about by rising domestic prices are contained.

30. Iraq's international reserves have played a critical role in helping ensure macroeconomic stability. The accumulation of foreign exchange reserves at the CBI allowed Iraq to stabilize the Dinar, reverse the dollarization process, and contain inflation. Reserve accumulation was facilitated by the high crude oil price up to mid-2008. For example, gross international reserves of the CBI increased from US\$31.4 billion at end-2007 to about US\$50 billion at end- 2008. In light of the fall in oil prices, CBI reserves are projected to decline to about US\$44 billion in 2009. Going forward, maintaining a healthy level of international reserves is crucial to preserve the stability of the Iraqi Dinar, and avoid the resurgence of currency substitution and inflation, with its accompanying socio-economic effects, particularly on the poor.⁶

C. Debt Sustainability and External Financing Needs

31. Further progress was achieved in debt restructuring, significantly improving Iraq's debt sustainability prospects. The final review of the second IMF SBA took place in October 2008 and was completed in December 2008. Completion of this review triggered the third and final stage of Iraq's Paris Club debt reduction agreement, for a total debt reduction of 80 percent in NPV terms. The final debt treatment reduced the total stock of debt due to Paris Club creditors to US\$7.8 billion. Based on the Paris Club agreement, Iraq will restart making payments on this debt stock by 2011. The IMF estimates Iraq's total government debt at US\$95.6 billion at end-2008, US\$90.3 billion at end-2009 and US\$30.9 billion at end-2010, assuming a debt reduction in 2010 by non-Paris Club creditors in terms comparable to the

R., M. Villafuerte, P. Medas, and T. Thomas (2008). "Managing the Oil Revenue Boom: The Role of Fiscal Institutions". *IMF Occasional Paper 260*, p. 15.

⁵ While exports overall were relatively steady, northern oil exports fell by 111,000 barrels per day in October 2009, largely due to a suspension of exports from Iraqi Kurdistan and a one-week stoppage of the main northern export pipeline. The stoppage of pumping along the Iraq-Turkey pipeline was due to an act of sabotage on the line near Mosul inside Iraq, the first such act for months.

⁶ The empirical literature has lent support to the view that "inflation is the cruelest tax of all" as it hurts the poor disproportionately. See e.g., Easterly, W. and S. Fischer (2001). "Inflation and the Poor". *Journal of Money, Credit and Banking*, Vol. 33, Issue 2 (May), pp. 160-178.

Paris Club agreement. Furthermore, most of Iraq's commercial debt was successfully renegotiated over 2004-6, leaving Iraq with an outstanding commercial debt stock of US\$5.2 billion by end-2007, down from the original US\$21.9 billion.

32. However, for these prospects to fully materialize, further progress is needed with respect to non-Paris Club debt restructuring. Negotiations are underway with non-Paris Club creditors. The United Arab Emirates announced full cancellation of Iraq's outstanding debt in July 2008. In addition, in March 2009, Iraq signed a bilateral agreement with Tunisia settling an outstanding debt of US\$183 million. The Paris Club Tour d'Horizon held in December 2009 indicated that comparable debt treatments had been completed with 58 out of 73 Iraq's sovereign creditors at the time. The Paris Club Secretariat had written to nearly all of the outstanding 15 sovereign creditors (all except Kuwait and Sudan), urging them to grant comparable treatment. Further progress is therefore needed to resolve the outstanding claims of official non-Paris Club creditors (mainly concentrated in the Gulf Countries) on terms comparable to those of the 2004 Paris Club Agreement. In addition, China announced that it will forgive 80 percent of Iraq's debt of US\$8.47 billion.

33. In the short term, Iraq is projected to face a major external financing gap. Mirroring the fiscal accounts, Iraq's current account balance will move from a significant surplus in 2008 to a major deficit in 2009. Projected estimates indicate a current account surplus of about US\$13.1 billion, or 15.1 percent of GDP, in 2008. With the fall in oil export receipts, a current account deficit in the order of US\$12.8 billion (or 19.4 percent of GDP) is preliminarily projected for 2009. The current account balance is projected to remain at the same levels – while still being in a deficit position – during 2010, due to increased imports to pursue the reconstruction and infrastructure upgrade as well as recovery of the private sector.

34. Oil prices are the central variable to understand Iraq's current account balance, as they explain the behavior of export revenues. Crude oil exports accounted for 98.6 percent of Iraq's total exports in 2008. The decline in exports is estimated at US\$22.7 billion between 2008 and 2009. Preliminary simulations indicate that Iraq's fiscal and export revenues are highly sensitive to minor variations in oil prices and oil export quantities.

Table 3. Iraq: Summary Table of External Financing Needs

	Preliminary		Projection	
	2008	2009	2010	2011
<i>(in percent of GDP, unless otherwise indicated)</i>				
Balance of Payments gap	..	..	4.2	1.7
Current account balance	15.1	-19.4	-21.0	-5.5
Interest payments to be paid	1.3	1.8	0.3	0.0
Potential portfolio capital outflow	0	0	0	0
Stock of Short-Term Debt	0	0	0	0
International Reserves changes (net, increase -)	-21.7	8.9	0.4	0.4
Stock of international reserves (end of period)	58.0	67.3	54.8	47.1
<i>(in US\$ billion, unless otherwise indicated)</i>				
Balance of Payments gap	..	..	3.4	1.5
Current account balance	13.1	-12.8	-16.8	-5.1
Interest payments to be paid	0.8	0.7	0.2	0.0
Potential portfolio capital outflow	0	0	0	0
Stock of Short-Term Debt	0	0	0	0
International Reserves changes (net, increase -)	-18.8	5.9	0.3	0.3
Stock of international reserves (end of period)	50.2	44.3	44.0	43.7
<i>Memorandum Items:</i>				
<i>Gross Domestic Product (US\$ billion)</i>	86.5	65.8	80.3	92.8
<i>Crude Oil exports (US\$ million)</i>	61.2	38.9	47.9	55.4

Source: Iraqi authorities, IMF and World Bank staff estimates.

D. Poverty and Social Development

35. Iraq was once known throughout the region for the quality of its education, health and infrastructure. However, as Iraq underwent a series of wars and international sanctions, the emphasis shifted from investment to maintaining a minimum level of consumption. Chronic lack of investment and maintenance in physical, institutional and human development drove down the average level of welfare and removed the opportunities for the most well-endowed to prosper. Meanwhile, high levels of spending on the food ration provided a floor on consumption, albeit through a highly inefficient and distortionary mechanism.

36. The recently-completed Iraq Household Socio-Economic Survey (IHSES) shows that poverty is relatively high but “shallow” in Iraq. In 2006-2007, socio-economic data for the nation as a whole was collected to analyze the extent and causes of poverty, and to support development of a practical poverty reduction strategy. Based on an official poverty line of ID 76,896 per person per month (real expenditure), poverty in Iraq is relatively high (with a headcount index of 22.9 percent) but “shallow” (with a poverty gap index of 4.5 percent).

37. Iraq has the lowest employment to population ratio in the region. Out of every 100 Iraqi adults slightly over one-third (38 percent) are employed, and 5 percent are unemployed (available and seeking work). The majority (57 percent) are not in the labor force – meaning they are not working and not seeking work. The labor force participation rate for women in the non-poor group is at 13.3 percent and 11 percent for the poor.

38. Refugees have slowly started returning home as security improves, but displacement remains a top concern. The United Nations High Commissioner for Refugees (UNHCR) estimates that more than 4.7 million Iraqis have left their homes as a result of the war. Of these, more than 2.7 million Iraqis are displaced internally, while more than 2 million have sought refuge in countries such as Syria and Jordan. According to the UNHCR, only a small number have returned home, many of which suffered secondary displacement as they found their property occupied.

39. Water and electricity supply remain unreliable according to the IHSES. Connection to public water networks varies from 98.3 percent of dwellings in Baghdad to just 45.6 percent in rural areas. However, only 12.5 percent of persons whose dwelling is connected to the public network report that their supply of water is stable. 29.2 percent report daily interruptions; 17.6 percent report weak water supply; and 16.4 percent report interruptions more than once a week. In rural areas, 26.1 percent of households use rivers and creeks and 4.7 percent use public taps. The public electrical grid is identified as the main source of electricity for 76.4 percent of individuals. However, it provides on average only 7.9 hours of power per day. The lowest rate is in Baghdad, with only 5.0 hours of power supply per day. Only 22.4 percent of persons are able to rely solely on the public network for electricity to their housing unit. 75 percent of individuals supplement the public network with one or two other power sources. On average, community generators provide 6.4 hours and private generators provide 4.0 hours of additional power per day. Iraq's current electricity capacity is 7,500 megawatts, short of the country's needs of 12,000 megawatts.

III. THE GOVERNMENT’S REFORM PROGRAM

40. The Iraqi Government’s growth strategy aims to promote economic diversification and reduce oil dependence by fostering private sector-led growth, rebuilding its physical and institutional infrastructure, and developing its human capital. While some business environment reforms have

been introduced, the political and security situation (in addition to remaining constraints to business) have not been conducive to sustained private investment in the non-oil economy. A coherent growth strategy can only be fully implemented as the political and security situation stabilizes further.

41. The Government's reconstruction and recovery program is outlined in the National Development Strategy (NDS) and International Compact with Iraq (ICI). The NDS was presented in July 2005 and structured around four pillars for sustainable development, which remain relevant to Iraq's present conditions: (i) strengthening the foundations of economic growth; (ii) revitalizing the private sector as the engine for growth and job creation; (iii) improving the quality of life; and (iv) strengthening good governance and improving security. The ICI was launched in May 2007 by Prime Minister Nouri al-Maliki and UN Secretary General Ban Ki-Moon as a platform for Iraq's cooperation with the international donor community. The ICI concentrates on four reform and investment areas as well as in two specific sectors: (i) public resource management; (ii) governance and institutions; (iii) economic reforms; (iv) social sector reform; (v) energy; and (vi) agriculture.

42. The reform areas supported by this proposed operation are fully in line with the priorities of the NDS, the ICI and other reform initiatives by the Government. The specific areas discussed in detail in what follows are those directly supported by the proposed DPL, and include: (i) the Poverty Reduction Strategy and prioritization of public spending; (ii) public financial management; (iii) financial sector reform; and (iv) reforms to the social protection system to increase its efficiency and fiscal sustainability. The Government is now developing a new Five Year Plan.

A. Poverty Reduction Strategy and Prioritization of Public Spending

43. Since 2003, the Government has focused on expanding the flow of oil revenue and little progress was made in expanding services or employment-generating sectors of the economy. The Government of Iraq's spending on social sectors remains well-below regional averages. Moreover, within these sectors, allocation of resources among geographic regions and among categories of spending remains largely *ad hoc*. For example, Iraq allocated 8 percent of total spending to the food ration in 2008; this is large in that it exceeds the 6.2 percent spent on education and the 4.7 percent on health.

44. To remedy weaknesses in the allocation of resources, the Government has been engaged since 2006 in analytical work which will help strengthen budget prioritization. It includes:

- In 2007, the Government conducted the first national household income and expenditure survey since 1988. The Iraq Household Socio Economic Survey provides detailed information about living standards, representative at the sub-governorate level.
- A High Committee for Poverty Reduction (PRSHC) was established, including high level representation from all key national ministries, from the Kurdistan Regional Government, from Parliament and from Iraqi academia. The PRSHC has overseen the analysis of causes and consequences of poverty using the household survey data. The analytical work shed light onto the low quality of public health and educational services and identified geographic areas where access to services is particularly problematic.
- The PRSHC developed a Poverty Reduction Strategy on the basis of the analytical work. The Poverty Reduction Strategy focuses on six areas: income generation, education, health, safety nets, housing environment, and gender. Within each area, the strategy identifies public spending priorities and related policy reforms.

45. **Spending composition is expected to change in favor of the social sectors in the medium term.** For example, health and education are allocated around 16 percent of total spending in 2009 compared to about 11 percent in 2008. Pro-poor spending may also be enhanced as a result of the implementation of the PRS, whose completion is a prior action of this operation. The first annual PRS monitoring report (which is a program outcome in the matrix) will assess changes in spending on basic services as well as related outputs and outcomes. Table 4 summarizes the recent evolution of priority spending in Iraq.

Table 4. Priority Spending in Iraq

Priority Spending	2007	2008	2009
	Est.	Est.	Budget
Education (as % of total spending)1/	7.3	6.2	9.9
Recurrent			
Staff expenses (as % of total staff expenses)	18.0	22.0	29.0
Services (as % of total spending on services)	2.9	3.1	3.3
Transfers (as % of total spending on transfers)	0.2	0.2	0.1
Capital (as % of total spending on capital)	4.2	3.7	2.9
Health (as % of total spending)2/	4.3	4.7	6.0
Recurrent			
Staff expenses (as % of total staff expenses)	5.1	7.9	8.5
Services (as % of total spending on services)	15.2	13.1	19.8
Capital (as % of total spending on capital)	3.6	1.9	3.0
PDS spending (as % of total spending)	10.7	8.0	6.1
Ministry of oil (as % of total spending)	0.2	4.4	5.4
Ministry of Agriculture (as % of total spending)	0.3	0.2	1.0
Recurrent			
Staff expenses (as % of total staff expenses)	0.5	0.6	0.6
Services (as % of total spending on services)	0.4	0.4	0.2
Transfers (as % of total spending on transfers)	0.0	0.4	9.7
Capital (as % of total spending on capital)	0.5	0.3	1.1
Infrastructure (as % of total spending) 3/	1.4	1.6	3.0
Capital (as % of total spending on capital)	11.4	10.3	6.9

Sources: Iraqi authorities and IMF staff calculations

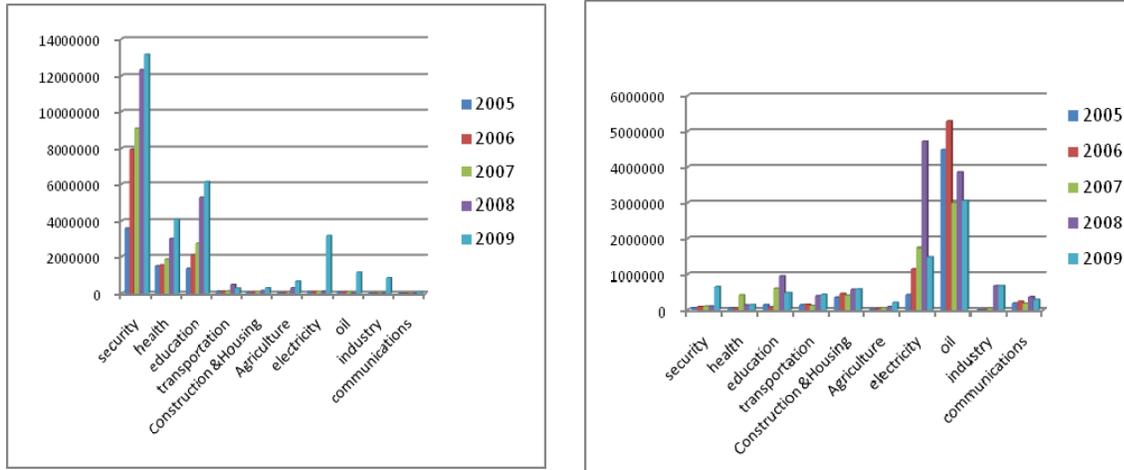
1/ includes Ministry of Education and Higher Education and Research

2/ covers Ministry of Health

3/ including Ministry of Planning, Ministry of Public Works and Ministry of Housing spending

46. **An assessment of recent trends in Iraq's budget composition indicates that recurrent and capital expenditures focus on distinct sets of priority sectors.** Security, education, and health have been the priority areas for the recurrent expenditure budget. The top priority sectors for the capital budget have been oil and electricity. This is reflected in Figure 2 below.

Figure 2. Composition of Recurrent and Capital Budgets, 2005-2009 (ID trillion)



Operational Budget 2005-2009

Capital Budget 2005-2009

47. **The PRS High Committee worked over the past 18 months on the development of the strategy.** In June, the PRSHC presented the poverty analysis and proposed spending priorities to a group of 120 donors and Iraqi stakeholders for their feedback. The PRSHC has also held discussions with members of the Council of Ministers and key parliamentary committees. The PRS document, outlining spending priorities and a plan for implementation and monitoring, was endorsed by the Council of Ministers in November 2009, and officially launched in a ceremony on January 14, 2010.

B. Public Financial Management Reform and Oil Revenue Management Mechanisms

48. **Sound public financial management (PFM) is critical to ensuring efficiency and accountability in the management of public resources.** Iraq is resource rich and has enjoyed a substantial increase in oil revenues in recent years. However, for the people of Iraq to benefit from its resource wealth, public finance reforms are a priority. Weaknesses in the PFM system not only have high costs in terms of allocative and operational efficiency but also create high levels of fiduciary risk. Iraq's commitment to implement the Extractive Industries Transparency Initiative (EITI) is a positive step and signal of political will to fight corruption, improve good governance and promote transparency in the oil and gas sector.

49. **In addition to exogenous factors, such as lack of security and political uncertainty, budget management in Iraq faces key impediments at the institutional level.** They include poor budget preparation and alignment with government priorities, poor investment project design and selection, inconsistent and cumbersome procurement procedures, ineffective mechanisms for cash management, monitoring and control of investment project implementation. By strengthening expenditure controls and improving aggregate fiscal discipline, PFM reforms are a critical element in safeguarding fiscal sustainability. In fact, some of the key impediments to fiscal sustainability in Iraq stem from inadequacies in Public Finance Management. The Government of Iraq has identified challenges throughout the PFM system from budget design and preparation to execution and reporting. It has also devised a time-bound action plan (the Public Finance Management Action Plan, PFMAP) to address them with assistance from the World Bank and the IMF.

50. The PFMAP is a broad program spanning several years developed by the Iraqi Government in cooperation with the World Bank, the IMF and other donors. The PFMAP focuses on three key areas: (i) budget design and preparation; (ii) public procurement; and (iii) cash management, control and accounting. It brings together efforts aimed at improving budget preparation and design with execution, accountability and control. The PFM project financed by the Iraq Trust Fund (ITF) covers most areas of the PFMAP in close cooperation with other donors. The US Department of Treasury is working in the areas of budget design and preparation, accounting and reporting and procurement while USAID is providing assistance in the area of information systems. UK DfID is working on areas of budget preparation and accounting. The IMF is also assisting with the Chart of Accounts. Joint efforts involving all the partners above included support in the redesign of the budget preparation process, a medium term budget strategy and budget call circular, the introduction of a new Chart of Accounts and ongoing development of accounting documentation. The design of commitment controls, cash release systems and a Single Treasury Account is the next logical milestone in this integrated effort.

51. The Government is fully committed to implementing PFM reforms. Progress in the areas of budget design and implementation are incremental but clear. In addition, progress has been made in areas that constrain government discretion. In particular, since 2007 there is a Medium-Term Fiscal Framework (MTFF) in place. A multi-year budget strategy and a budget with a hard fiscal ceiling were introduced in 2009. Furthermore, financial reports and audits are prepared earlier and are more accurate. In the past, it was not uncommon for closing accounts to be delayed by several months. Today, the maximum delay is 60 days. Iraq has adopted the GFS Chart of Accounts. DFI, CBI and State Owned Banks are audited by international audit firms and the Board of Supreme Audit reports are back on schedule after multi-year delays in the past. Finally, in 2009 Iraq avoided the introduction of a supplementary budget adding significantly to the credibility of the budget.

52. Work in the area of cash management and control (commitment control, disbursements and accounting) is especially important and will lead gradually towards a Single Treasury Account. These Government efforts will significantly reduce the amount of resources circulating in the system reducing both inefficiency and opportunities for abuse. In addition, the work on implementing recently-completed procurement legislation - including the establishment of a Procurement Regulatory Agency - will significantly reduce fiduciary risks in this important area.

53. A critical element in Iraq's overall fiduciary framework is the Development Fund for Iraq. The DFI is the sole legal account for all of Iraq's oil revenues. This is a bank account located at the Federal Reserve Bank of New York. It is overseen by the International Advisory and Monitoring Board (IAMB) as established by the UN Security Council Resolution 1483 (2003). The DFI is the main financing source for Iraq's budget. Despite shortcomings, it has afforded Iraq a level of transparency unparalleled for oil dependent countries in the region. It also ensured the integrity of Iraq's oil revenue envelope at a time of great uncertainty and instability with competing claims against government revenues from actors within and outside the country. The DFI is also a precursor to a possible future petroleum revenue fund which could fulfill revenue stabilization and saving functions. The maintenance of a single petroleum account with robust transparency and accountability measures would be a structural benchmark under the proposed successor SBA. See Box 2 for a more detailed discussion.

54. The Government of Iraq is moving towards fulfilling the candidacy requirements for the Extractive Industries Transparency Initiative (EITI). The launch event of the Iraq EITI process (IEITI) was held in Baghdad in January 10, 2010. EITI candidacy is a priority for the Government at the highest level, facilitating management of Iraq's resources and revenues transparently for the benefit

for all Iraqi people. Several key steps were taken towards this goal: (i) a decree from the Council of Ministers created the Iraq EITI National Secretariat and appointing its Head (Secretary-General); (ii) the Secretariat is in the process of being appropriately staffed; (iii) media articles were published explaining EITI to the public; and (iv) work is underway on a draft EITI work plan, the Multi Stakeholders Working Group (MSWG) Charter and preparation for launch event, including publicly advertised invitations to Civil Society Organizations (CSO) to consultation meetings. The Government is working closely with the World Bank, which is providing technical assistance to Iraq's EITI candidacy process.

Box 2. Iraq's Oil Revenue Management Framework

Iraq's central mechanism for oil revenue management is the Development Fund for Iraq (DFI). All of Iraq's oil revenues are deposited at the DFI on the basis of UNSCR resolutions dating back to 1995. The purpose of the DFI at inception is to monitor Iraq's exports under the Oil for Food program and ensure that Kuwait compensations set aside calculated as a percentage of oil revenues are properly deducted.

The mechanism is quite simple: buyers of Iraqi oil deposit money directly into DFI. A sale is not complete unless the money is on the account. Government of Iraq currently has full control of the account after the 5% Kuwait Compensation set aside is deducted.

After the war of 2003, all of Iraq's frozen assets were transferred to the DFI, which was then placed under the control of the Coalition Provisional Authority and monitored by the International Monitoring and Advisory Board (IAMB). The IAMB includes among others the Chief Controllers of the World Bank and the IMF. The DFI is audited annually by an international auditing firm, most recently KPMG.

The DFI account is held at the Federal Reserve Bank of New York. Since July 2004 the account is owned by the Ministry of Finance and managed in trust by the Central Bank of Iraq. DFI funds are protected from seizure by the UNSCR resolutions and by a US Presidential Executive Order.

The UNSCR establishing DFI has been extended every year and was extended in December 2010 again. This is dictated by the fact that the DFI is still needed to ensure that 5% Kuwait compensation set aside is deducted. The Government has requested the extension of the DFI arrangement. The US Executive Order is also extended annually and is up for renewal in May 2010. The extension of the order is a key element in the Strategic Framework Agreement signed between Iraq and the US in early 2009.

Most audit report qualifications do not pertain to the DFI account and its management per se, but rather upstream and downstream from it. Most issues concern the way funds are used by spending units in the execution of the budget.

The DFI could be interpreted as a *de facto* oil stabilisation fund without a withdrawal rule. Cash accumulates at the DFI when Iraq is running a budget surplus and vice versa. The DFI offers a single transparent point for oil revenues and is a key starting point for any revenue management policy. The key factor that distinguishes the DFI from a typical oil fund is the lack of a formal fiscal rule governing (limiting) withdrawals from the fund. The DFI could be seen as a precursor to an oil fund.

While well-designed oil funds can help avoid the "resource curse", particularly if they are appropriately integrated with the budget, they are far from being sufficient. Their key contribution is to minimize the impact of volatility on public spending and the economy at large. Well-managed oil funds can offer alternatives for investing oil revenues and managing them over time to reduce dependence and support private sector growth. However, a sustainable fiscal policy can be achieved through sound fiscal management and strong public financial management systems, with or without the use of special fiscal institutions such as oil funds.

The extension of the DFI for another year under the joint monitoring of the IAMB and the new Iraqi led Council

of Financial Experts will preserve Iraq's oil revenue framework during a critical transitional period. In the meantime, work should start on the development of a successor regime for DFI which fulfils the criteria of transparency, accountability and single petroleum account. Helping Iraq maintain a material balance at the DFI through the SBA and DPL is also important. Another key requirement for the preservation of the DFI is the maintenance of international guarantees and protections.

Full reconciliation of financial flows within the state-owned oil companies and the budget, as well as domestic physical flows of crude oil and oil derivatives, is critically necessary to have an accurate picture of Iraq's oil revenue envelope. The Bank plans to collaborate closely with the Fund in assisting the Government of Iraq in this regard as part of the upcoming Public Expenditure Review exercise. A key prerequisite is the installation of domestic metering systems in export terminals and pipelines. The metering installation process is in an advanced stage, and has already been completed for the Al-Basra oil export terminal.

In addition, the Bank will launch work on the Fiscal Aspects of Oil Revenue Management in Iraq, possibly as part of the upcoming Country Economic Memorandum. This work will focus primarily on tools and policies to manage oil revenue volatility, including through an assessment of the relevance for Iraq of special fiscal institutions such as oil funds and fiscal rules. The goal is to help avoid "boom and bust" cycles in public spending as a result of oil revenue volatility.

B.1. Budget Design and Preparation

55. Weaknesses in medium term fiscal planning have led to *ad-hoc* budgeting and pro-cyclical government spending which contributes to fiscal sustainability problems. The *ad hoc* nature of budgeting is manifested among other things in the practice of supplementary budgeting which has been used in the last few years. This practice undermines the credibility of Iraq's budget formulation process, since the original budget is not adhered to and a supplementary budget is customarily introduced. Notwithstanding the fact that contingencies may arise during the year, these should be provisioned for in the annual budget and the practice of supplementary budgets halted or a process that does not undermine budget credibility instituted.

56. Budget preparation is also hampered by a weak connection between budget preparation and government priority setting. Iraq also suffers from a poor quality of investment budget and project design, further reducing the credibility of the budget and contributing to under execution of investment programs. As noted before, the design and implementation of the PRS, combined with key PFM reforms, would help address these concerns.

57. Efforts in this area aim at introducing a credible medium term fiscal framework on the basis of sound economic and fiscal forecasts and the use of top down budgeting to bolster fiscal discipline. The PFMAP calls for improving the process and content of the budget call circular and the introduction of credible fiscal envelope and ceilings. It also calls for closer integration between government wide priority setting and sector specific planning, on one side, and the budget process, on the other, *in tandem* with quality improvement in both processes.

B.2. Public Procurement

58. Strengthening of Iraq's public procurement system is a key component of the PFM reform process. The patchwork of old and new rules and regulations and lack of coordination between the various bodies involved in the procurement process has been identified by the Government as a major contributing factor to both abuse and inefficiency in budget implementation. The Public Finance

Management Action Plan and the new Procurement Law call for streamlining and harmonizing the procurement process by adopting consistent government wide and sector specific Standard Bidding Documents and procedures and establishing a Regulatory Agency to oversee uniform implementation across government levels. The new procurement law will mark a major milestone in progress on public procurement, and make Iraq a leader in the region in this area.

59. **The Government has an Inter-ministerial task force** of procurement experts, representing the major ministers and departments to prepare a draft of Public Procurement Law to align the public procurement system in the country with internationally recognized best practice. The new draft law submitted to the Government of Iraq in 2008 was the result of consultations with the public sector, private sector, and civil society through workshops in Baghdad, Erbil, and Amman.

60. **An adequate implementation of the new legal framework for public procurement would significantly improve economy, efficiency, transparency, and equal opportunity.** This would be evidenced by (i) the enactment of the new Public Procurement Law after approval by the Council of Representatives; (ii) the issuance by Council of Ministers of the Implementing Regulations of the new Public Procurement Law; (iii) the establishment of the Public Procurement Regulatory Authority (PPRA) by a Decree of Council of Ministers; and (iv) the issuance by MoPDC of the Standard Bidding Documents (SBDs) based on the new Public Procurement Law and Regulations.

B.3. Cash Management, Control and Accounting

61. **A proper cash management, control and accounting will help attain effective budget execution and mitigate potential risk of waste and abuse.** The Government is working in addressing weaknesses in areas such as cash management and government accounts, and the state of budget execution particularly when it comes to investment.

62. **The Public Finance Management Action Plan (PFMAP) calls for *inter alia* the introduction of commitment control and cash release systems.** Together with new Government Finance Statistics (GFS)-based Chart of Accounts, these systems will allow for a more robust cash management and control. The adoption of the Chart of Accounts and the Budget Strategy will greatly facilitate investment budget execution. In addition, these measures are critical to improving overall PFM in Iraq, as they will allow for better cash management and control. The aim of these measures is to increase the efficiency of public expenditures as well as improve accountability.

63. **After adopting the new GFS-based Chart of Accounts in 2007, the Ministry of Finance proceeded to implement it throughout the system starting with monthly and annual financial statements.** This is often done by mapping the new final statements to accounts produced according to the legacy system. The Accounting Reform Committee was established in October 2009 to codify the new Chart of Accounts and produce an Implementation Manual which includes detailed description of the Chart of Accounts codes and guidance notes on accounting policies and procedures.

64. **The implementation of an automated Financial Management Information System (FMIS) is an integral part of the PFMAP.** It is also a prerequisite for other components, including a Single Treasury Account. The Government of Iraq is working with the USAID and independently to introduce a system that is compatible with Iraq's needs.

C. Financial Sector Reform

C. 1. Overview of the Financial Sector Prior to Reforms

65. The Iraqi financial sector is dominated by the banking system, accounting for more than 90 percent of the financial assets. As of June 2008, the banking system comprised 29 banks, of which two are state-owned commercial banks, 23 are private banks, and 4 small state-owned specialized banks. Non-bank financial markets are underdeveloped. The capital markets, besides government debt instruments, are practically nonexistent. Iraq had a nascent stock exchange which was closed after the privatization of state-owned enterprises (SOEs) program ended, and has recently resumed operations, but trading remained thin. The state-owned insurance companies – largely inactive during the previous regime – are small compared to the size of the economy.

66. In turn, state-owned banks dominate the banking system with around 90 percent of the banking system's total assets, amounting to about US\$26 billion. Of the total banking system's network of 550 branches, 450 are of state-owned banks. Rafidain Bank and Rasheed Bank are the largest state-owned banks in Iraq (accounting for 70 percent of the system's assets), and the only ones with a national network of branches (147 and 142 branches respectively). In addition to these two large state-owned commercial banks, there are four small state-owned specialized banks, namely Agriculture Co-operative Bank, Industrial Bank of Iraq, Real Estate Bank of Iraq, and the Ishtiraqi Bank—the latter was recently renamed Iraq Bank and will soon be folded into Rafidain Bank. The state-owned specialized banks have 69 branches in total, and have about 2,000 employees.

67. The state of the banking sector reflects historical developments. Iraq nationalized its commercial banks in 1964. Ten years later, four banks were merged into one—Rafidain Bank, which had a commercial banking monopoly in Iraq until the second state-owned bank, Rasheed Bank was established in 1988. Along with its normal commercial banking operations, Rafidain Bank also conducted some transactions for the Government that are part of central bank activities in most countries. Rasheed Bank has a large domestic branch network but no foreign branches. Before the first Gulf war, Rafidain was the Arab world's largest commercial bank with total assets of US\$47 billion and a branch network outside of Iraq, notably in Beirut, Cairo, Amman, Bahrain, and Sanaá.

68. The private banks are small and their activities are limited to transactions services to a select clientele. Their operation began only in 1993, when private banks with nationwide branches were allowed to be established in Iraq. Despite the proliferation of private banks, their contribution to the banking sector remains minor. There are also several foreign banks in Iraq, and some have invested in Iraqi private banks that—once the security situation further improves—will bring new expertise and competition into the system.⁷

69. Financial intermediation is weak in Iraq and access to finance is limited. Although the banking sector is the main component of the Iraqi financial system, it offers few credit services, despite the fact that many of the branches have resumed operations after the 2003 war. Compared to some other countries in the MENA region, the deposit base and loan portfolio of Iraqi banks is small relative to GDP. The credit culture is poor with very little extension of credit to the private sector. Total bank lending to the private sector is equivalent to only 3.6 percent of GDP in 2008 (Table 5). Very few banks offer loans with more than one year maturity and most banks lack the expertise to offer appropriate credit facilities or

⁷ This includes HSBC, Westminster-Abbey, and National Bank of Kuwait.

assess risks. Correspondingly, the asset structure of state-owned commercial banks is heavily tilted toward government securities and involves little credit to the corporate sector, be it public or private.⁸

Table 5. Rafidain and Rasheed Banks: Selected Indicators (in billion Iraqi Dinar)

	Rafidain Bank	Rasheed Bank
Year founded	1941	1988
Number of branches	147	142
<i>Of which in Baghdad</i>		69
Loans and Advances	402	219
<i>Of which non-performing</i>	209	139
Assets on balance sheet	21,295	6,019
Liabilities on balance sheet	20,934	5,222
Equity	361	797
Estimated capital shortfall after risk and valuation adjustments	15,370	359

Source: E&Y Financial and Operational Audits (2008).

70. Despite years of conflict, the state-owned commercial banks continue to be trusted by the public, as evident in increase in deposits in terms of volume and number of depositors. They are also the backbone of the payments system and are one of the instruments the Government has to make social security and other nationwide payments. While the state-owned banks have wide name recognition, command a reasonable level of public trust, and are fairly liquid, they need a clear reform strategy to make a more significant contribution to development. Prior to reforms, the financial sector in Iraq faced various challenges due to the low levels of competition, relatively high intermediation costs, limited innovation, and dominance of state ownership. The banking system was burdened by high levels of NPLs, while the non-bank segment is characterized by underdeveloped markets, thin trading in equities, weak corporate governance, and weak infrastructure for effective payment systems.

71. In addition, the financial system in Iraq has been characterized by a weak supervisory and regulatory framework, as well as poor financial institutional infrastructure. Prior to 2004, the supervision functions were compliance-based rather than risk-based. The structure and efficiency of a financial system is greatly shaped by the nature of its institutional infrastructure, which includes information exchange setup; payments system; financial reporting; and accounting standards. In Iraq, however, the institutional infrastructure, including credit information, the payments system, financial reporting and accounting standards were weak and inadequate. Although Iraqi authorities are making efforts to improve the institutional framework, there still remain large gaps. This called for the adoption of a comprehensive reform strategy for the banking sector.

C.2. The Banking Sector Reform Program (2008-2012) and other Financial Sector Reform Initiatives

72. It became apparent by early 2007 that the Government needed to move forward with a financial sector reform program, aimed at enhancing the sector's soundness and efficiency. This program would contribute to building a system, able in the medium term to provide efficient financial services competitively. This in turn would help ensure effective mobilization of funds, and allocating them to the most productive investments.

⁸ State-owned enterprises (SOEs) were financed from the budget, in the form of grants, and by hidden subsidies.

73. **The objective of the reform program is to strengthen the performance of the banking system—the dominant financial institution, accounting for 90 percent of the system.** A key tenet is to improve its capacity to provide quality financial services. This program has the potential to make a critical contribution to Iraq’s economic growth, prosperity, and macroeconomic stability. Successful implementation of the reform program would ensure that the overall financial system, and the banking system in particular, would contribute better to economic development and growth.

74. **This reform program was endorsed by the Government of Iraq in February 2009.** The program was developed with the support of the World Bank and in coordination with the different partners in development that are actively working on developing the financial sector in Iraq. As mentioned earlier, the program focused primarily on banking sector reform. The program was based on the findings and recommendations of the independent comprehensive audits of the two state-owned banks that were undertaken by Ernest & Young in 2008. It represents the most far-reaching, and comprehensive set of financial reforms to have been ever launched in Iraq over the past decades.

75. In terms of *institutional and operation restructuring* of the state-owned commercial banks, the reform program sought to develop an overall organization structure, including business units organization.⁹ It includes improving human resources processes, such as the development of a personnel strategy, clear rules and regulations for employees, assessment of skills and needs, job descriptions and qualifications and career paths, rewards management and performance evaluation. Institutional restructuring also involves developing the information technology infrastructure; focusing on an information technology platform covering all operational aspects (such as marketing and sales tools, credit tools, risk management tools, and information technology related consumer products, as well as connectivity of branches and supervision authority); the flow of information; and the information security system.

76. On *financial restructuring* of the state-owned commercial banks, the Government is committed to clean up a large portion of the existing NPLs. Settlements would also be reached on other bad debts, and selling of assets. An in-depth program of improvement in information technology, procedures, risk management, governance, and staff skills would allow them to operate on a commercially viable basis in increasingly open and competitive markets, without running the risk of incurring new NPLs. This would entail: (i) restructuring of the balance sheets (including inherited debts and losses); (ii) capital adequacy (classification of assets and provision policy, capital base); (iii) budgeting, planning and performance management; (iv) accounting system in compliance with national standards and in line with international good practices; (v) comprehensive reporting system of financial results; and (vi) cost recovery and re-pricing of financial products. Also, positive strides have been made with regard to raising minimum capital requirements. The settlement process of outstanding private claims as part of the liquidation of the London branch of Rafidain Bank is well underway and the process to liquidate fixed assets has begun.

77. Underpinning the whole program was a major effort aimed at *strengthening the regulatory and supervisory authorities*. CBI embarked on a comprehensive program of capacity building covering extended areas of the regulatory and supervisory functions, with the objective of moving from compliance to risk-based supervision. This includes undertaking a thorough and comprehensive review of banking supervision processes; an updating and enforcement of a set of regulations in line with international

⁹ This includes, retail, corporate and investment banking; risk management units; management of information systems; governance, control and support units (audit, legal and compliance, anti-money laundering, human resources and organization, shared services, financial functions, and risk functions).

standards; and making new recruitments and developing training. These initiatives are supported by the World Bank, the IMF and the US Treasury.

78. *Strengthening the financial sector institutional infrastructure* is a key pillar in the reform program. This includes improving internal audit and compliance in the banking system through developing further the internal audit (processes, audit framework and methodology, effectiveness of internal audit); and compliance with laws, regulations and instructions (scope of improvement, compliance framework and methodology, as well as organization). Another key element was developing the payments, clearing, and settlement systems through the installation of the real time gross settlement (RTGS) system in early 2009. This will reduce total processing time of checks and transactions. Specific efforts include improving and strengthening the information infrastructure, as well as the credit registration system.

D. Reforms to the Social Protection System

D.1. Public Distribution System and Social Safety Net Reforms

79. **The Iraqi food ration system — the universal Public Distribution System (PDS) — was introduced in 1991 in response to the declining availability of food imports under the UN sanctions and played a crucial role during that period.** By making transfers to all households, the food ration helped avoid a humanitarian crisis. The PDS remains equally important today: 99 percent of Iraqis have a ration card to provide fixed quantities of 10 commodities on a monthly basis. Among the poor, who rely heavily on the rations in their diet, the PDS provides 78 percent of calories actually consumed which constitutes about 16 percent of their total income. Hence, given the uniquely large coverage of the system, the reform of the PDS can only be gradual and needs to be accompanied by putting in place a well-targeted safety net system. Just repealing the PDS is not an option and would have grave consequences for the population, especially the poor: the poor would get poorer (the poverty gap would double from 4.5 percent to 9.1 percent) and poverty rates (which currently stand at 24 percent) would soar to more than 34 percent of the population.

80. **The PDS is by far Iraq’s largest safety net program: the other main safety net program — the Social Safety Net (SSN) managed by the Ministry of Labor and Social Affairs (MOLSA) — is comparatively much smaller.** Whereas the budget of the PDS was US\$5.87 billion in 2008, the budget of the SSN was about one-eighth the size (US\$0.67 billion). The Ministry of Trade operates the PDS in close co-operation with three principal state-owned enterprises: the State Company for Grain Trading, the State Company for Grain Processing, and the State Company for Foodstuff Trading. In addition, the Ministry of Transport supports distribution through the State Transport Company. Procurement practices lack transparency and do not ensure value for money, and contribute substantially to delays and prices that are considerably above world market prices.

81. **The Government decided to launch a medium-term reform program of the PDS for several reasons.** First, as indicated above, because the food ration is provided to all households in Iraq, the cost is very high. Second, the management of the food ration is poor, making it vulnerable to waste, theft and corruption and which leads to inefficiencies that are necessary to address. Rough calculations suggest that it costs more than US\$6 to transfer US\$1 of benefits to a poor person. Third, the food ration’s heavy reliance on state-owned enterprises and non-competitive procurement crowds out the private sector and reduces the efficiencies associated with competition. These reforms are expected to take several years to be fully implemented.

82. Recognizing the rationale and impetus for reform, in 2009 the Government established a High Committee to oversee the reform process for the PDS.¹⁰ The High Committee is chaired by the Secretary General of the Council of Ministers and includes Undersecretaries from the Ministries of Finance, Planning, Trade, Labor and Social Affairs, Deputy Governors of Baghdad, Al Anbar and Babil, representatives from the Kurdistan Regional Government and Iraqi Parliamentarians. The High Committee is tasked with development of a concrete action plan for rationalizing the food ration which includes the following key elements: (i) implementing proposed exclusion criteria in the current PDS, such as exclusion of government officials from the PDS system that signals the commitment to move towards a targeted system; (ii) devising an effective targeting tool that supports a robust transition from universal to a targeted program – the SSN program would be a natural candidate to scale up if it can be improved in terms of its targeting effectiveness as explained below; (iii) reducing the number of products included in the ration; and (iv) assessing the feasibility of assigning management of food ration to a decentralized level of government. Such a decisive reform of PDS if implemented would not only aid critical improvements in the existing PDS but also afford fiscal space for developing a more comprehensive social protection program in Iraq.

83. The existing cash transfer program (SSN Program) will need to become more efficient through better targeting that will be facilitated through the development of a more effective targeting tool.

The SSN program was initially introduced as a policy response in 2004 to address rising poverty levels in Iraq. Since 2004, the number of beneficiaries of the program has expanded rapidly, buoyed by the fiscal surpluses enjoyed during 2007 and 2008, and now reaches about a million households. However, the implementation of the program used categorical targeting¹¹ mechanisms, which diluted its impact on the poor – it currently reaches less than 10 percent of the poor population while maintaining overall budget levels since 2008. The use of categorical targeting, while effective in initially capturing vulnerable individuals and households, was expanded during the fiscal boom years, leading to rapid increase in the number of included households. Little verification was done to assess beneficiary income and/or consumption levels. The development of an objective and much improved targeting tool is therefore an essential first step to improve the effectiveness of the SSN program. In addition, institutional capacity needs to be developed to implement the improved targeting tool and administer the program. Once the SSN program is targeted well, it can form the basis for streamlining across the various safety net programs alluded to above, and especially to credibly assist a transition out of the universal PDS to a targeted program.

84. The Government has expressed its intention to rationalize the MOLSA SSN program, and to introduce a comprehensive and coordinated package of social assistance interventions. Foremost in terms of rationalizing the MOLSA SSN program is the intention to gradually shift from the current simple

¹⁰ To support intentions of reform of PDS, a high-level workshop on the PDS reform took place in June 2009, facilitated by the World Bank. It was attended by all relevant stakeholders that are critical for the reform process, including the General Secretary of Council of Ministers, Deputy Ministers from Finance, Trade and Planning, Prime Minister's Economic Advisor, select members of Parliament and Chief of Staff of Council of Advisors. This workshop also benefitted from participation of the World Food Programme and authorities from India and Indonesia who highlighted reforms and implementation challenges for transitioning from universal to targeted programs. During the workshop, participants developed Terms of Reference for a High Committee for PDS Reform, including development of recommendations on three topics: targeting, reducing the number of commodities in the ration basket, and management of the PDS.

¹¹ The following categories are contemplated: (i) households with no income; (ii) independent individuals with no income who are not living with families; (iii) unemployed individuals; (iv) households with disabled members; (v) widows or divorced women; (vi) totally disabled persons including the blind and paralyzed; (vii) underage orphans (below 18 years old); (viii) families of prisoners sentenced to more than one year in prison; (ix) displaced families, abandoned women, families who lost their head of household (because of accidents, kidnapping etc.); (x) disabilities and injuries caused by acts of terrorism; and (xi) married students continuing their university studies with no other source of income.

categorical targeting to exploring more robust targeting mechanisms informed by sound methodologies such as proxy means testing. The authorities recognize that a robust methodology to identify the poor will assist in achieving the overarching objective of effectively targeting the poor and vulnerable Iraqis with adequate safety net provisions that include not only rations/cash transfer but also workfare, microcredit, training, employment support, and unemployment insurance. Furthermore, MOLSA intends to exploit the institutional structures they have in place to engage beneficiaries at a national scale and at the local level. For example, in addition to the headquarters center in Baghdad, MOLSA manages two social safety net centers in Baghdad (one each in Karkh and Rasafa), as well as social safety net centers in all governorates, which have been involved in the application and vetting process of applicants. In addition, MOLSA has established links with banks and post offices for disbursing the cash benefits in the SSN program. These are all important considerations as MOLSA embarks on reform of the programs alluded to above. However, the ambitious agenda described above will require substantial capacity building in the medium-term to (i) manage the transition from universal to targeted PDS, (ii) devise an effective targeting tool that can ensure minimal exclusion of the poor, and (iii) coordinate across various diverse social protection programs to minimize overlap among beneficiaries while addressing the needs of various vulnerable groups. The Government has requested technical support from the World Bank to facilitate the envisaged reform.

85. In addition to the PDS and the SSN programs, the Government has also initiated a number of other social programs to provide vulnerable groups with opportunities for productive participation in the economy. These programs include training support, employment and placement services, as well as microfinance. These programs have received modest budgetary allocations. In addition, these programs were introduced in an *ad hoc* manner, without a comprehensive approach to the provision of a full package of social assistance strategies to address not only income generation, but also income protection for the poor.

D.2. Pension Reform

86. The pension reform legislation of the existing public sector pension scheme became effective in December 2007. The pension law (Law 27) passed in January 2006 was suspended as it was widely deemed to be unsustainable. Subsequently, the Government amended the law in December 2007 (referred to as the Unified Pension Law in the text of the law) to improve financial sustainability and alter the design of public sector pensions in line with good international practices. While the Unified Pensions Law presents a significant improvement, there remain substantial challenges in terms of the Government's capacity to implement the law, and in ensuring a sustainable old-age income protection mechanism for Iraq. The World Bank, IMF and other international organizations have been supporting Iraq in this reform.

87. The Unified Pension requires the merger of the public and private sector pension schemes by 2010. The amendment to Law 27/2006 includes a provision on the merger of the public and private sector pension schemes by January 1, 2010. In particular, the National Board of Pensions (NBP) has been established as the unifying body of the mandatory pension schemes. Those retired prior to January 17, 2006 will see little effect due to the reform. However, a new State Pension Fund (SPF) has been established to provide pension benefits to public sector workers retiring on or after January 17, 2008. The SPF is an administrative unit within the unifying umbrella of the NBP. Furthermore, the existing Social Security System, the private sector pension scheme, is to be transferred under the authority of the NBP. The envisioned merger is desirable in as much as it alleviates the segmentation of the labor market along the public/private divide.

88. Even if all the implementation issues of the new Pension Law are resolved, the mandatory pension system in Iraq will cover only one fourth of the labor force. This represents a low level from a social protection point of view, and is 10 percentage points below the already low average coverage rate in the Middle East and North Africa region. The coverage level of the national pension systems in MENA is below that of the one in Iraq only in two countries: Yemen and the West Bank and Gaza. The coverage rate reflects upon the capability of the pension system to prevent old-age poverty. A low coverage rate does not only reflect limited overall access to the pension system, but it also signals that only the already advantaged social groups have access to this social protection instrument. The primary beneficiary group of the pension system is public sector employees who already possess a solid and secure source of income compared to the uncovered masses in the informal sector. According to the Iraq Poverty Assessment, only 15 percent of poor workers have pension coverage, compared to 34 percent of nonpoor workers.¹² Both the goals of poverty alleviation and accelerating private-sector-led economic growth point to the direction of extending social insurance coverage over the medium- to long-term.

IV. BANK SUPPORT TO THE GOVERNMENT PROGRAM

A. Objectives, Rationale and Timing

i. Objectives

89. The main objective of the proposed DPL is to mitigate the impact of the current fiscal crisis on Iraq's economy and to support its medium-term economic reform program, thereby helping the country improve fiscal sustainability and reducing its fiscal and socio-economic vulnerability to sudden drops in oil revenues.

90. More specifically, the project supports the following goals:

- *Helping bridge the financing gap created by lower oil prices;*
- *Strengthening budget management and prioritization to enable more efficient and effective use of Iraq's own resources;*
- *Strengthening the financial sector;*
- *Helping to cushion the social impact of lower oil revenues by reforming social safety nets and the pensions system.*

91. The common theme of improving Iraq's fiscal sustainability prospects brings these specific goals together. First, strengthening budget management and prioritization is critical to ensure aggregate fiscal discipline and reduce waste and unproductive expenditures. Second, financial sector reform will help reduce the direct budgetary burden of state-owned banks as well as the contingent liability they represent. Third, a social protection system can only be truly efficient if it is fiscally sustainable, which can be achieved through the rationalization of the costly and large Public Distribution System and through pension reform.

¹² By law, all public sector workers and employees of private firms with five or more employees are entitled to pensions, medical insurance, disability, sickness, and maternity leave benefits. In reality, only 32 percent of wage workers in enterprises of 5–10 employees are covered. This increases to 84 percent of wage workers in enterprises with more than 50 employees.

ii. Rationale

92. **Budget support to Iraq should be seen in context of inherent political vulnerabilities the country faces which could be compounded by its current fiscal difficulties.** These difficulties were triggered by the revenue shock, brought about by steeply declining oil prices in the wake of the global financial crisis. The Bank and IMF support will help Iraq's fiscal stabilization efforts and enable the country to continue its reconstruction and service delivery initiatives – a prerequisite to consolidate political stability and security improvements as the country enters into an electoral period. Smooth economic and political transition is critical for all stakeholders in Iraq.

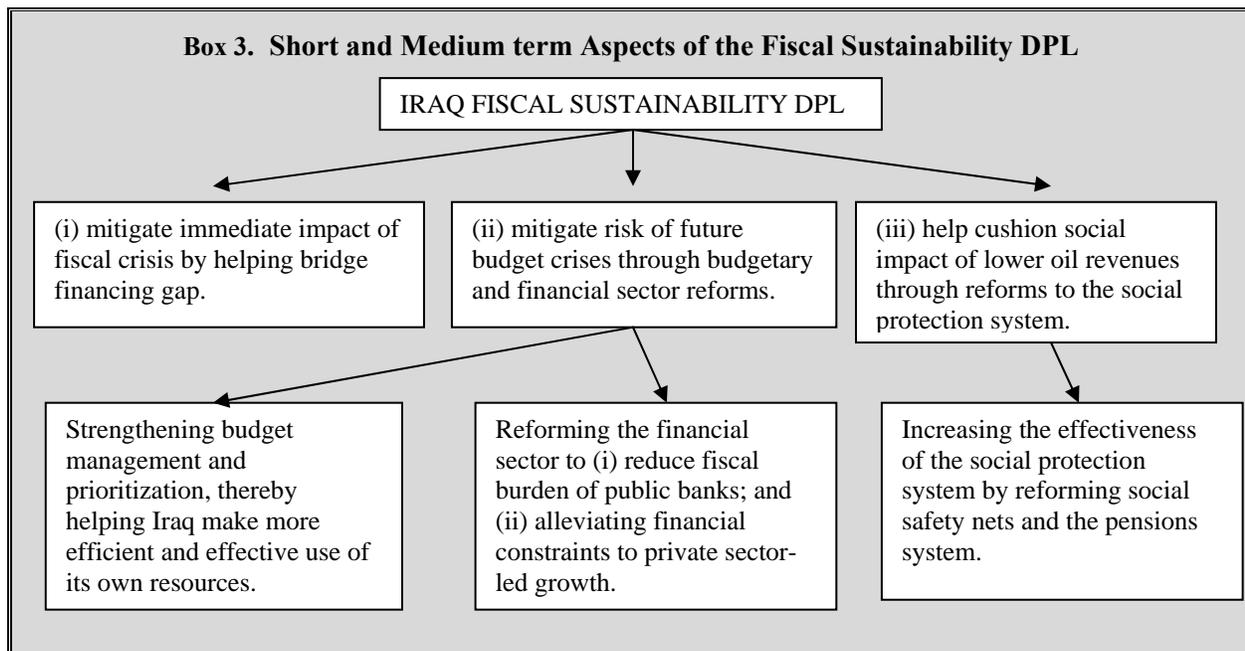
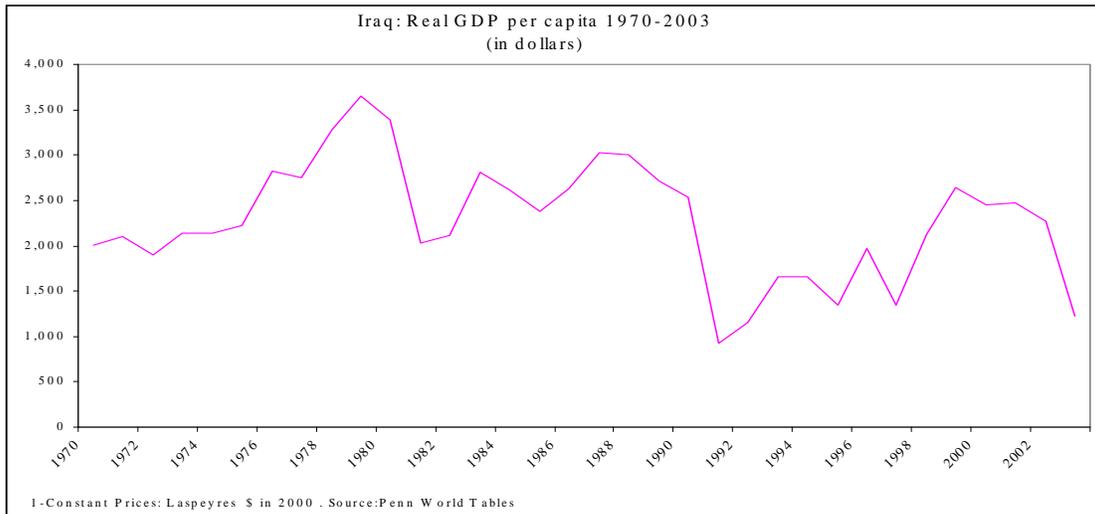
93. **Financial assistance to Iraq's budget by the Bank and the Fund will help sustain an adequate level of public expenditures in Iraq, in order to strengthen the delivery of key public services and rebuild infrastructure.** Reflecting lessons from the experience of other post-conflict and fragile states, Iraq public spending could be impacted by severe fiscal cuts that can undermine stability and security as insurgent groups could exploit the weaknesses of a State undergoing a fiscal crisis.

94. **Success in mitigating the impact of fiscal crisis on Iraq's economy will involve a combination of additional financing and fiscal adjustment.** Together with the IMF's proposed Stand-By Arrangement (SBA), this DPL would help relieve the immediate financing pressures on the budget, and would also help focus energies in key reform areas for the adjustment process, both in the short and medium terms. The Bank is supporting the Government in the adjustment process, both directly and through its participation in the design of the new SBA with the IMF. In the reform areas described in the previous section, Bank support to the adjustment process is critical for the success of the financial turnaround.

95. **In addition to assisting Iraq with a short-term financing need, the DPL would open the door for a robust medium-term reform dialogue with Iraq.** The ongoing Bank assistance and policy engagement to Iraq create the opportunity to seek commitment in well-defined areas for reform, providing the basis for a strong medium-term reform program for Iraq.

96. **The importance of a medium-to-long term focus cannot be overstated.** Although Iraq is facing a short-term cash-flow problem, its current fiscal woes are a symptom of a medium-to-long term issue: an excessive dependence on oil revenues and the consequent socio-economic vulnerability to abrupt changes in international oil prices. Figure 3 shows that Iraq's real per capita GDP – a broad measure of welfare – follows a “boom-bust” pattern, with growth accelerations followed by growth collapses. Such collapses have been caused either by falling oil prices or periods of warfare. Therefore, a reform program needs to contain measures that can also help make inroads into longer-term development goals that help address Iraq's vulnerability to such high degree of instability in real per capita GDP. Box 3 illustrates the short and medium term aspects of the DPL.

Figure 3. Iraq: Real GDP per Capita, 1970-2003



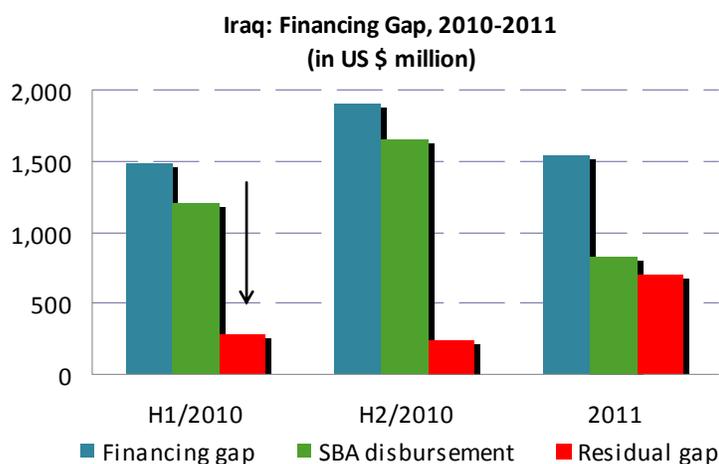
iii. Timing

97. The proposed timing of this DPL responds to both financing and political economy considerations.

- From a financing gap perspective, it is critical that the Bank and Fund coordinate closely on the pace of disbursements from their respective operations. Specifically, Iraq would need budget support from the Bank during the first half of 2010. As shown in Figure 4, the financing gap for the first six months of 2010 is estimated at US\$1.5 billion. In the second half of

2010, the projected gap is US\$1.9 billion. Under the proposed successor Stand-By Arrangement, the IMF expects to disburse US\$460 million (25 percent of the quota) at Board approval, US\$736 million (40 percent of the quota) following the first review of the SBA (after end-May 2010); another US\$1.657 billion following the second review (after end-August 2010), and US\$460 million and US\$368 million in the first and second half of 2011, respectively. In addition, it should be noted that the IMF SBA is intended to be a mix of disbursing and precautionary, in two respects. First, as long as oil prices stay below US\$73 per barrel for Iraqi oil, the program would be a disbursing SBA. If prices rise above US\$73 per barrel and oil exports are above 2.1 mpbd, it could become a precautionary, non disbursing SBA at the Government's discretion. Second, if the 2010 investment budget is under-executed (i.e., with a rate of execution below 93%) at the time of the second review, the program could also become precautionary again at the Government's discretion.

Figure 4. Iraq: Financing Gap, 2009-2011 (US\$ million)



- From a political economy perspective, given Iraq's recent election history, it is expected that there would be a caretaker government in Iraq for several months after the elections.** The previous general elections were held in December 2005 for a four-year government. Each province contributed a predetermined number of seats to the Council of Representatives (CoR). Voters chose lists representing their confessional affiliation and/or regions, and Shiite and Kurdish parties emerged dominant. The CoR was inaugurated on March 16, 2006. A 37-member cabinet led by Prime Minister Maliki was voted on May 20, 2006. Given the multitude of political alliances at present, it cannot be assumed that any one party or political force would be able to constitute a majority in the Council of Representatives. This could be expected to lead to protracted negotiations to form a national unity government. Waiting for the new Government to be in place before preparing this operation with new prior actions appropriate to the context at that time would substantially delay the needed financial support to Iraq. It is therefore critical to ensure that the proposed DPL disburses while a government committed to a reform dialogue with the Bank is still in place, for two main reasons: First, a timely processing of the proposed DPL will help lock in key aspects of Iraq's structural reform agenda, which the World Bank supports, and which will continue to be implemented through the ongoing TA program. Second, a continuing financing gap during the first half of 2010 could exacerbate potential tensions in an already politically-charged period, as it could compel Iraq to curtail essential expenditures, including investment and reconstruction spending.

98. **Furthermore, in the absence of timely external assistance to close its financing gap, Iraq’s post-election Government may be forced to rely on its international reserves to meet its short-term financing needs.** This could be an important risk factor if a post-election, caretaker government faces pressures to increase spending in face of an uncovered financing gap, potentially undoing the hard-won stabilization gains made over the past few years. As noted, Iraq’s international reserves play a key role in the stabilization of the Iraqi Dinar and provide an additional cushion against unforeseen shocks.¹³

B. Link to Interim Strategy Note (ISN)

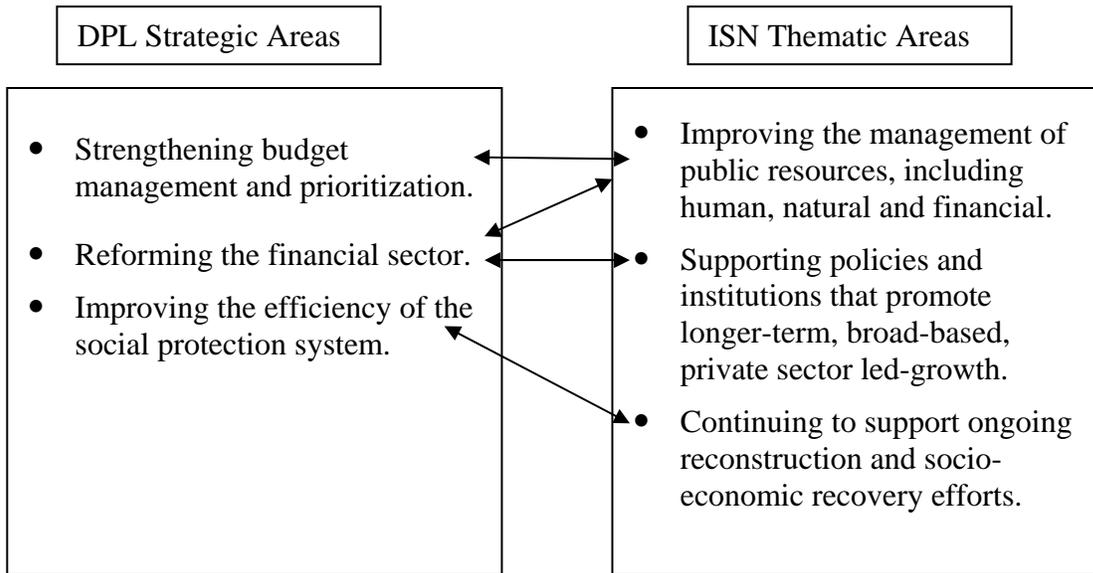
99. **Although this DPL was not originally included in the Interim Strategy Note 2009-11 (ISN) presented to the Board of Executive Directors in March 2009, it is fully consistent with the ISN thematic areas.** The ISN aims to: (i) support ongoing reconstruction and socio-economic recovery; (ii) improve governance and the management of public resources; and (iii) support policies and institutions that promote broad-based, private sector-led growth. The three DPL pillars are linked as follows to the ISN themes: Social safety nets are part of the first theme of the ISN; budget management and prioritization is at the core of the second; and financial sector reform is a key component of the third. In all three areas there are ongoing Bank-supported investment operations being implemented in Iraq as well as past, current or planned AAA work. These links are summarized in Figure 5. The DPL also meets the selectivity criteria for new Bank financed projects that the third ISN introduced.¹⁴

100. **Furthermore, by energizing the reform efforts in three key policy areas, the DPL will help implement the ISN and achieve its objectives.** First, the DPL brings together in a single operation different strands of the reform program supported by the ISN. Second, by frontloading support to Iraq’s reform agenda, the DPL can help meet key ISN goals more quickly than through investment projects. Third, by providing resources to Iraq at a time of critical need, the DPL opens the door for engagement with Iraq on its medium-term development agenda as envisaged by the ISN.

¹³ The CBI is *de facto* and *de jure* independent. In fact, the Central Bank Law prohibits the CBI from financing the budget. It is important to bear in mind that Iraq adopted an exchange-rate-based stabilization policy against inflation, and the independence of the CBI was critical to ward-off pressures to finance the budget deficit. The threat to macroeconomic stability associated with a potential dip into international reserves comes from the impact this might have on the public’s confidence in the Iraq Dinar and the level of the nominal exchange rate, and from the risks of reigniting inflation in Iraq, which is particularly harmful to the poor.

¹⁴ Interim Strategy Note mid FY09-11, Paragraph 52.

Figure 5. Link to the ISN



C. Collaboration with the IMF and Other Donors

101. **This operation and the proposed new IMF SBA are mutually reinforcing and complementary to each other.** In designing the Bank support to the Government’s reform program, account was taken of the fact that the IMF’s proposed SBA is expected to focus on many of the same reform areas (such as PFM and banking reform). Therefore, the back-to-back mission with the IMF in September – October 2009 provided an opportunity to ensure that the DPL reform program and the Fund’s structural benchmarks are complementary and mutually reinforcing. Further collaboration and complementarity is expected in the areas of oil revenue management. In implementing its technical assistance programs in Iraq, the Bank has also been working very closely with key technical departments at the Fund, such as the Fiscal Affairs Department (on PFM reform) and the Monetary and Capital Markets Department (on financial reform issues). In addition, the IMF and the Bank have been working very closely together in the implementation of previous IMF arrangements with Iraq. In particular, Bank support has been instrumental for the success of critical reform actions under the previous SBA such as the design and launching of the Public Financial Management Action Plan, the Banking Sector Reform Action Plan, the international audits of the Rafidain and Rasheed Banks, the amendment to the Pension Law to make it fiscally sustainable, and the revisions to the Consumer Price Index (CPI) weights drawing on information from the 2007 Household Survey.

102. **In all three pillars of the proposed DPL, the underpinning technical assistance projects are funded through the multi-donor Iraq Trust Fund (ITF) financed by contributions from 17 donors¹⁵ and administered by the World Bank.** The status of ITF projects is reported regularly through the International Reconstruction Fund Facility for Iraq (IRFFI) website and through annual formal reports to donors¹⁶. Some specific information on donor coordination for each of these Pillars follows below.

¹⁵ Australia, Canada, European Commission, Finland, Iceland, India Japan, Korea, Kuwait, Netherlands, Norway, Qatar, Spain, Sweden, Turkey, United Kingdom, and United States.

¹⁶ See www.irffi.org for details.

103. **The preparation of the Poverty Reduction Strategy (PRS) has been supported through a grant from the ITF.** In addition, a variety of donors have participated in workshops to provide feedback to the Iraqi PRS High Committee, most notably the June 2009 workshop which included over 100 participants from the donor community and Iraqi stakeholders. More recently, the Bank has coordinated closely with the UN agencies on encouraging the Government to adopt the priorities of the PRS into their Five Year National Development Plan.

104. **The Public Finance Management project, also financed through the ITF, is carried out in close cooperation with the IMF, European Commission, the US Department of the Treasury and the UK Department for International Development.** These partners played a direct role in the design of the project and are joining directly in its implementation by participating in working groups and meetings, contributing to outputs and in some instances co-financing joint activities. Furthermore, the Government of Iraq convenes regular meetings for all interested donors in the area of Public Finance Management to apprise them of progress in implementing the PFMAP and to solicit inputs into the process.

105. **The authorities have also sought financial and technical support from the IMF, US, and the World Bank to carry out its financial sector reform program.** There has been close collaboration between all development partners. The World Bank and the IMF and other donors in Iraq in banking sector reform, namely, European Commission, US Treasury, and Financial Services Volunteer Corps (FSVC) have been playing a vital and active role in restructuring the banking sector. The Banking Sector Reform Project, financed through the ITF, aims to support the Iraqi authorities in the implementation of Phase I of the “Iraq Banking Reform Strategy” (2008-2012) and its Action Plan. The World Bank has been coordinating donors’ initiatives to avoid overlap, ensure complementarity, and address key issues on a timely and priority basis. Coordination with other donors will prevent duplication of efforts by strengthening complementarity to help the government implement the rest of the reform agenda. To this end, an ‘Iraq Banking Reform Donors Group’, chaired by the World Bank, has been formed to coordinate efforts related to both technical and financial support provided to the Government of Iraq in the area of banking reform. This DPL will build on the ongoing Bank’s efforts undertaken and at the same time complement work being undertaken by other development partners.

106. **The World Bank has been working closely with USAID in supporting social safety nets and pension reform.** On the social safety net side, the World Bank and USAID have been working closely since 2005 to support the capacity building for the Ministry of Labor and Social Affairs (MOLSA) to plan, manage, and implement the cash transfer program. Initially, this was done through USAID’s Second Economic Governance Program (EGII), and has recently been transferred to the USAID/Tatweer program. The ITF-financed Social Protection Project aims to help strengthen the policy, management, and administrative capacity of the Government to develop, manage, and monitor pension and social safety net reforms. For pensions, the World Bank has worked closely with the IMF to ensure that the amendments to Law 27/2006 to ensure a more fiscally sustainable pension system that is consistent with international best practices. In addition, the World Bank has worked closely with USAID in the development of the amendments to Law 27/2006, and in the provision of capacity building support to the National Board of Pensions.

D. Relationship to Other World Bank Group Operations

107. **The proposed DPL is underpinned by six key ITF-financed companion projects designed to build capacity and provide technical assistance in each of the three pillars, namely:**

- **Public Financial Management (PFM) Reform Project (US\$18 million; FY09).** This project aims to improve allocation, execution, transparency and accountability in the mobilization and use of all public resources. Cross-cutting reform of the PFM will be addressed by strengthening budget formulation, execution and control, improving public financial reporting, strengthening public procurement and developing capacity in PFM, both at the central and the governorate levels.
- **Emergency Banking Sector Reform Project (US\$10 million; FY09),** which supports the implementation of Phase I of the Banking Sector Reform Strategy—Action Plan (2008–2012), aiming at improving the performance and soundness of the two state-owned banks—Rasheed Bank and Rafidain Bank, as well as strengthening the capacity of the supervisory functions of the Central Bank of Iraq.
- **Emergency Private Sector Development Project (US\$65 million; FY05),** which aims to help Iraq strengthen its institutional capacity and build essential communications infrastructure to help foster the development of the private and financial sectors, and increase investment and economic growth.
- **Household Survey & Policies Project (US\$9.1 million; FY07),** which aims to strengthen the ability of the Government to make informed policy decisions for poverty reduction, employment generation and safety nets. The project has financed a comprehensive household income and expenditure survey, data analysis and development of a Poverty Reduction Strategy. It also provided extensive capacity building to the Government in support of the data collection, data analysis and strategy development.
- **Social Protection Project, (US\$8 million; FY06),** which aims to strengthen the policy, management and administrative capacity in the Ministry of Labor and Social Affairs and the Ministry of Finance to develop, manage, and monitor pension and social safety net reforms.
- **Proposed Pension Reform Implementation Support Technical Assistance: Improving Old-Age Income Security in Iraq (US\$6 million; FY10),** which is designed to support the Government to implement the provisions of the Unified Pension Law (Law 27/2006 as amended in December 2007). The technical assistance also has medium-term objectives to support unification of the public and private pensions systems; and long-term objectives to support the Government to develop a long-term old-age income security strategy for Iraq with a focus on the expansion of social insurance coverage.

108. **In addition, the Bank is exploring with the Government potential technical assistance support for Social Safety Nets implementation.** Areas for potential TA support include: (i) improving targeting of the poor and vulnerable; (ii) developing an integrated package of safety nets and social assistance interventions; (iii) finalizing the draft Social Security Law; (iv) Enhancing institutional capacity and improving SSN administration; (v) designing and implementing income support mechanisms for the unemployed; and (vi) developing active labor market programs.

109. **IFC has also been active in Iraq.** Since the inception of IFC's work in Iraq in 2003, IFC has undertaken a range of investment and technical assistance activities. The primary focus of the program has been to support for the financial sector, the construction sector, and small and medium enterprises

(SMEs).¹⁷ The Iraq Small Business and Finance facility (ISBFF) was approved by the IFC Board in December 2003, and has been operational since mid-2004.¹⁸

110. In addition, through *PEP-MENA*, IFC's advisory services since 2003 included: (i) training to around 250 Iraqi bankers (ii) completing SME advisory support to INB in collaboration with Rabobank of Holland, (iii) supporting, together with World Bank and UN-Habitat the development of a local land development strategy and the construction industry sector; (iv) successfully implementing its SME management training program, Business Edge; and (v) brought together key investors, government leaders, donors, and the private sector.

111. **IFC will continue to support the development of the financial sector and banking capacity building and restructuring in Iraq.** In addition to enhancing SMEs access to finance as well as supporting microfinance activities. IFC has been in continuous contact with Iraqi and foreign businesses and project sponsors exploring opportunities in the country and many are poised and ready once the investment environment improves.

E. Analytical Underpinnings

112. **The proposed DPL is underpinned by a series of recently completed and ongoing analytical and advisory tasks, programmatic technical assistance, and projects.** The proposed policy actions and outcomes are founded on a continuous engagement of the Bank in the three areas covered under the proposed DPL, with a list of key analytical and advisory activities presented in Table 6.

113. **The ongoing assistance in public financial management initiated in 2005 underlined the need for further fiscal consolidation and more efficient public spending in Iraq.** The Bank has gained insight in this area through both formal Economic and Sector Work (ESW) as well as through its technical assistance program. A Public Expenditure and Institutional Assessment (PEIA) (2008) provides an integrated assessment of PFM performance, highlighting the main impediments for efficient public resource management, the impact of PFM weaknesses and prospects for reform planning and implementation. Two prior actions for this operation are focused on improving the budget allocation process. The PEIA highlighted the importance of rationalizing levels of public expenditure and prioritizing sector resource allocations in order to reflect better the Government's policy priorities. To this end, the Bank has been supporting the Ministry of Finance in developing a framework for a medium-term budget strategy reflecting Government policy priorities and medium-term macroeconomic and fiscal projections. A workshop was held with Bank support in May 2009 on the 2010-2012 Budget Strategy. The National Poverty Reduction Strategy, which was informed by a Poverty Assessment (2009), will further improve the alignment of budgetary allocations, particularly in the social sectors. The PEIA also refers to the importance of exercising oversight of fiscal risk by ensuring that the national budget and financial statements cover all the major revenue and expenditure programs of government and that full reporting of the central government's financial relationships with sub-national government is essential to maintaining fiscal discipline and accountability. A study on Sub-National Public Reform (2005) and an

¹⁷ IFC committed US\$115 million in three projects since 2003. IFC has 10 percent stake in Credit Bank (US\$5 million), provided US\$12 million loan to Iraq National Bank (INB) to support SME lending, and committed US\$99 million to support the construction of the first private cement company in Suleimanya, Kurdistan.

¹⁸ The facility has funding of US\$83 million, comprising an investment component of US\$68 million to provide funding to local financial institutions for on-lending to micro and SMEs and a technical assistance component of US\$15 million to create capacity on the ground for MSME financing. Iraq National Bank (INB) was the first bank to be selected under the Facility.

ongoing policy note on Subnational Finance look at fiscal relations between national and subnational units. A Public Expenditure Review is planned for FY11 to examine public expenditure policy issues.

114. **The PEIA also highlights the importance of transparency in government activities, which encompasses making use-friendly financial information available to the public and Parliament as well as employing a system of budget classification which permits meaningful analysis and interpretation of that information.** The prior action on the Chart of Accounts for DPL1 and the indicative measures for the DPL2 represent milestones in achieving timely availability of information of fiscal accounts and alignment of budget codification and the Chart of Accounts.

115. **Greater economy, efficiency and transparency in public expenditures will improve prospects for fiscal sustainability.** In 2005, the World Bank conducted an Operational Procurement Review (OPR) of the public procurement system and provided recommendations to the Iraqi Government, the World Bank, and the donors. The major issue facing public procurement in Iraq is the uncertainty of public procurement laws and regulations and the scattered regulations that create opportunities for corruption and substandard practices in public procurement, which will be difficult to prevent without a clarification of the procurement legal framework first. Technical assistance activities were also held in the context of the ITF-financed Second Multi-Sector Institutional Capacity Building Project. This combination of AAA and TA have helped form the basis for the new procurement law that will constitute a major improvement in public spending, and will make Iraq a leader in the region on this area.

116. **In the preparation of the Banking Sector Reform Project, the Bank supported the Government in developing its Financial Sector Strategy Action Plan 2008-2012.** This Action Plan provided the main underpinning for identifying the priority areas for the financial sector reform component of this DPL. It was based on the independent audits and full due diligence of the state-owned commercial banks and the Central Bank of Iraq by Ernst and Young. The Terms of Reference for the independent audits were prepared by the World Bank based on the FSAP approach. The key recommendation from the audits and Action Plan was the institutional, operational and financial restructuring of the two state-owned Banks. Four prior actions under this DPL were based on these recommendations.

117. **The ongoing programmatic assistance on social protection both on the food ration system, pension and social safety net reform identified the key priority areas for reform.** There are three main Bank supported analytical pieces for the gradual approach to rationalize the Public Distribution System: (i) Considering the Future of the PDS (2005); (ii) Management of the PDS (2007); and (iii) a Poverty and Social Impact Assessment of PDS reform options found in Annex 4, as well as a programmatic series of workshops for PDS reform from 2007 to present. The reports found that the PDS is effective in reaching the poor, but costly and inefficient, and provide recommendations on improving the management of the PDS. The reform areas in the DPL matrix reflect the fact that this is a sensitive, yet needed reform, given the unsustainability and inefficiency of universal coverage.

118. **The social protection reform underpinnings are embodied in a number of Bank-supported activities.** They include the technical assistance of the Emergency Social Protection Project, a policy note on social protection, covering safety net, labor market and pension issues, together with a series of policy workshops, a World Bank policy note (“Pensions in Iraq: Improving Financial Sustainability, Efficiency and Equity in the Iraqi Pension System: A Concept for Reform”) (2006), and an ITF-funded Pension Reform TA project that is expected to be approved shortly. Key findings were that the existing information base is insufficient to design social safety nets and pension systems as these require detailed

information on program costs and beneficiaries, that cash based safety nets have been small and not well-targeted to the poorest and the current pension system is financially unsustainable, benefit formulas and eligibility conditions do not respect basic norms in terms of design and coverage is limited. This operation supports the next step in each of these reform areas.

Table 6. Analytical, Advisory, and Operational Activities Underpinning the DPL

Policy Area	AAA, TA and Project Activities	Type	Status
Budget Management and Prioritization	Poverty Assessment (2009)	ESW	Completed
	Program of capacity building workshops for Household Survey and Policies for Poverty Reduction Project (2006-present)	Advisory	Ongoing
	Public Expenditure and Institutional Analysis (2008)	ESW	Completed
	Report on Sub-national Public Financial Management (2010)	ESW	Ongoing
	TA activities under the Second Multi-Sector Institutional Capacity Building Project	TA	Ongoing
	Operational Procurement Review (2005)	ESW	Completed
	EITI technical assistance	Advisory	Ongoing
	PFM Reform TA Project	TA	Ongoing
Financial Sector	Banking Sector Strategy—Action Plan 2008-1012	Advisory	Completed
	Independent audits of state-owned banks (Rafidain and Rasheed)	Inputs to Audit TORs	Completed
	Banking Sector Reform TA Project	TA	Ongoing
Social Protection	Considering the future of the Iraqi Public Distribution System (2005)	ESW	Completed
	Improving the management of the PDS (2007)	ESW	Completed
	Poverty and Social Impact Analysis of PDS Reform Options (2009)	ESW	Completed
	Series of capacity building workshops for PDS reform (2007-present)	TA	Ongoing
	Emergency Social Protection TA Project	TA	Ongoing
	Pension Reform Policy Note (2006)	ESW	Completed
	Pension Reform TA Project	TA	Ongoing

F. Lessons Learned

119. **As an input to the recent ISN, the Bank carried out a stocktaking of the Bank Group engagement with Iraq over the past five years.** The goal of the stocktaking exercise was to identify the key bottlenecks for the implementation of the Bank’s program in Iraq and extract lessons for future engagement.

120. **The Bank’s initial engagement with Iraq had been in the areas of emergency reconstruction, capacity building projects, technical assistance and analytical work, though in line with post-conflict environments, there is a gradual shift to the medium- and long-term agenda, notably public financial management and private sector development.** Difficulties in the operating environment have led to delays in many of the active projects reaching their development objectives, although implementation is picking up some emergency reconstruction projects have already yielded results. Some of this experience is relevant for the DPL. Operating environment issues that affect the implementation of the Bank program include security; the policy and institutional environment; and counterpart engagement. Issues and lessons learned pertinent for the DPL are outlined below.

121. **First, for planning purposes, it should be assumed that progress in the security situation over the year life of the DPL would continue to be slow and incremental, with a risk of reversal due to the political situation. Therefore risks should be mitigated and expectations kept realistic.** Lack of security affects Bank Group activities in a number of ways: (i) the safety of Iraqi officials and Iraqi Bank staff is at constant risk, and their ability to move among various government offices and project sites is extremely limited; (ii) Bank Group staffs ability to visit Iraq is constrained and when it is possible, it tends to be limited to secured areas in Baghdad or with high levels of security arrangements or Kurdistan, offering limited direct interaction with high officials; (iii) most large or lengthy missions and interactions with Iraqi counterparts are held outside the country. As the DPL is a transfer of funds and policy dialogue, the security situation is less of a constraint for this operation than for investments which require movement of goods, contracting workers, and visits to project sites. Policy dialogue is taking place for each of the DPL areas through the technical assistance projects, from which the DPL will benefit. The DPL has also been designed for Iraq's specific context with regard to the results that can realistically be expected to be achieved. Prior actions include some process milestones which are appropriate in Iraq's context, as they are critical to suit the needs of a modern developmental state.

122. **Second, despite the mixed results obtained thus far in terms of institution building in Iraq, it continues to be an imperative for the Bank's engagement with Iraq, and its delivery should be customized to Iraq's needs and the Bank's own ability to meet those needs.** Iraq's policy and institutional environment has not been conducive to a smooth implementation of the Bank Group's assistance program. Main bottlenecks include: (i) weakened capacity of ministries and implementing agencies as a result of the large-scale departure of talented professional staff; (ii) likewise, pre-existing private capacity to a large extent eroded by the exodus of skilled professionals; (iii) lack of familiarity with World Bank procedures; (iv) a decision-making process hampered by an atmosphere of uncertainty and by a history of overly centralized processes; (v) lengthy procedural delays and inability or unwillingness to delegate functions within ministries; and (vi) frequent changes in leadership leading to turnover in government counterparts at all levels. As such the underpinning technical assistance projects in each of the three DPL pillars are key.

123. **Third, interest and engagement on the part of ministries and implementing agencies should be a criterion for Bank support.** Counterpart engagement has been uneven across ministries and implementing agencies. In addition, lack of qualified human resources combined with frequent changes in ministry staff slow implementation and often setback progress. Government commitment exists in each of the three DPL pillars as demonstrated by the active engagement in each of these areas.

124. **Fourth, additional flexibility is needed in the design and programming of Bank assistance, in the scope for experimentation with alternative implementation arrangements.** As the physical investment projects encountered delays, this DPL will offer a new fast-disbursing approach which may be more successful and pave the way for a more medium- to long-term engagement in Iraq.

125. **In addition to the Bank's stocktaking specific to the Iraq context, the 2009 Development Policy Lending Retrospective¹⁹ indicates that programmatic DPLs have allowed the Bank to stay aligned with country processes and respond more flexibly to changing country circumstances and government priorities, and that this flexibility has been essential to strengthen ownership of reforms supported by the Bank.** The programmatic nature of this DPL is suitable for Iraq's changing

¹⁹ 2009 Development Policy Lending Retrospective, "Flexibility, Customization, and Results", OPCS, The World Bank, August 5, 2009.

circumstances which require flexibility, particularly given upcoming elections and therefore ownership of and commitment to the reform agenda.

V. THE PROPOSED OPERATION

A. Operation Description

126. **The choice of reform areas follows clear selection criteria.** The reform package should concentrate on areas which are priority for the Iraqi Government as well as for Bank support under the Interim Strategy Note (ISN); where the Bank has a comparative advantage; and which could help mitigate Iraq's fiscal and socio-economic vulnerability to sudden drops in its oil revenues.

127. **The proposed pillars of this DPL meet the selection criteria outlined above.** The proposed pillars are: (i) strengthening budget management and prioritization; (ii) reforming the financial sector; and (iii) improving the efficiency of the social protection system. All three areas are clearly consistent with the ISN themes (see Figure 5), support key aspects of the Government's reform program and reflect the Bank's comparative advantage. They are underpinned by ongoing Bank-supported investment operations as well as past, current or planned AAA work. In addition, and as discussed further below, reforms in these areas can help mitigate some of the more extreme effects of oil dependence and revenue volatility.

128. **The fiscal sustainability goal provides a common thread for the three selected reform areas.** First, strengthening budget management and prioritization is critical to ensure aggregate fiscal discipline and reduce waste and unproductive expenditures. Second, financial sector reform will help reduce the direct budgetary burden of state-owned banks as well as the contingent liability they represent. A functioning banking system is a necessary component of private sector development needed to diversify the economy for non-oil growth. Third, a social protection system can only be truly efficient if it is fiscally sustainable, which can be achieved through the rationalization of the costly and large Public Distribution System and through pension reform.

129. **The program includes 11 prior actions for this proposed operation and 10 indicative triggers for a successor DPL.** This DPL contains a robust reform program that is appropriate to Iraq's situation, and which complements the structural reform agenda under the IMF's proposed new SBA. Under Iraq's circumstances, some process-oriented actions are crucial to paving the way for deeper reforms and institution building (see subsection V.B). The proposed program will therefore prepare the ground for even stronger policy reform actions as part of the Government's reform program. The prior actions and indicative triggers are described in Box 4.

Box 4. Prior Actions for DPL I and Indicative Triggers for DPL II

Strengthening Budget Management and Prioritization

A) Prior Actions

- The Ministry of Finance has adopted a framework for medium term budget strategy reflecting Government policy priorities and medium term macroeconomic and fiscal projections.
- The National Poverty Reduction Strategy, which outlines public spending priorities in the social sectors, has been adopted by the Council of Ministers.
- The Shura Council has completed the review of the draft of the Procurement Law, to be submitted to the Council of Ministers.
- The Ministry of Finance has issued a decree establishing a High Level Committee to develop the Manual for implementing the Chart of Accounts.

B) Indicative Triggers

- The Ministry of Finance has convened the Budget Strategy Committee for 2011 budget; and has issued the call circular, consistent with medium-term macroeconomic and fiscal projections.
- Monthly fiscal accounts for the execution of the 2010 budget have been issued no later than 60 days after the end of the month.
- Board of Supreme Audit (BSA) has completed audit of 2006 Government Accounts.
- The Ministry of Finance has issued the Manual for the implementation of the Chart of Accounts.

Reforming the Financial Sector

A) Prior Actions

- Settlement of at least 20 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007.
- The Restructuring Oversight Committee (ROC) has endorsed the Banking Sector Reform Strategy and the Action Plan for the operational and institutional restructuring of the two state-owned commercial banks—Rafidain Bank and Rasheed Bank.
- The Central Bank of Iraq (CBI) has approved its new organizational chart and a detailed program for capacity building in banking regulation and supervision.
- CBI has introduced a real time gross settlement (RTGS) payments system complying with international standards.

B) Indicative Triggers

- Completion of Phase 1 of the operational and institutional restructuring of Rafidain Bank and Rasheed Bank.
- Completion of Phase 1 of the banking regulation and supervision capacity building in program..
- The RTGS system is fully operational.

Improving the Efficiency of the Social Protection System

A) Prior Actions

- The Council of Ministers Secretariat has established a High Committee mandated to propose a time-bound action plan for rationalization of the Public Distribution System (PDS).
- The Council of Ministers has endorsed a policy of reforming the current Social Safety Net through

improved targeting methods.

- The management and governance structure of the State Pension Fund (SPF), has been put in place through (i) approval of the executive regulations and by-laws of the SPF by Council of Ministers; (ii) appointment of the General Manager of the SPF by the Prime Minister; and (iii) appointment of the Board of Directors of the SPF by the Minister of Finance.

B) Indicative Triggers

- The Council of Ministers has approved a time-bound action plan for the rationalization of the Public Distribution System.
- The Government has prepared an implementation plan detailing exclusion criteria for targeting the PDS.
- The National Board of Pensions has launched the actuarial policy analysis to assess the Unified Pension Law's fiscal sustainability.

130. **The prior actions and indicative triggers aim to support specific long-run policy objectives.** More specifically, each pillar of the proposed DPL supports long-run policy objectives as follows:

- *Strengthening budget management and prioritization:* (i) alignment of the budget with Government priorities; (ii) alignment of budgetary allocations with the PRS; (iii) establishment of a public procurement legislative and regulatory framework that achieves economy, efficiency, transparency and equal opportunities for the public expenditures; and (iv) a timely, accurate and informative financial reporting allowing for control and accountability as well as analysis.
- *Reforming the financial sector:* (i) institutional and operational restructuring of state-owned commercial banks; (ii) full adherence of the banking supervisory system to the Basel Core Principles for Effective Banking Supervision; and (iii) an efficient and effective financial transactions settlement system.
- *Improving the efficiency of the social protection system:* (i) improvement in the efficiency and effectiveness of the targeting of social safety nets, allowing for enhanced social impact, enhanced fiscal sustainability of the program, and reduced fiscal pressures on the budget; (ii) availability of package of social assistance interventions, informed by rigorous analysis of available data including the household survey and international experience; and (iii) provision of old-age income security to plan members by the pension schemes in a financially sustainable manner by offering adequate and affordable benefits.

B. Policy Areas

A.1. Strengthening budget management and prioritization.

131. **As noted in the ISN, the main policy challenge facing Iraq today is how to transform oil wealth into public goods and services and create the conditions for a diversified economy. The budget is the framework within which this transformation takes place.** The budget reflects the Government's policy priorities and its ability to deliver services. The budget process could be notionally divided into two interwoven cycles - a policy cycle and a financial cycle. The first includes policy design, planning, implementation, evaluation and review. The second includes financial planning, budget design, approval and execution, auditing and reporting.

132. **This pillar aims to ensure that budgetary management and prioritization helps improve fiscal sustainability while serving the long-term development needs of the Iraqi population.** It accomplishes this objective by identifying clear priorities for spending allocation, and by supporting sustainability in aggregate spending levels and an efficient budget process. This pillar comprises two areas, reflecting respectively the policy cycle and the financial cycle: (i) effectiveness of public expenditures, in line with Iraq’s Poverty Reduction Strategy (PRS); and (ii) public financial management (PFM).

133. **While not directly addressed by this operation, revenue management issues are a key part of overall budgetary management and thus of the Bank’s policy dialogue with Iraq.** Adequate management of Iraq’s revenues, particularly those from oil, is another key ingredient in achieving and maintaining fiscal sustainability. The importance of oil revenue management is particularly critical in oil-dependent economies such as Iraq and will be a key focus area for Bank’s analytical and advisory engagement going forward. The Bank has initiated work on a study on Intergovernmental Aspects of Revenue Management in Iraq. This study will comprise one policy note on intergovernmental revenue management and sharing catered to the Iraqi context; one policy note on non-oil taxation and assignments showing positive examples of countries able to remobilize taxation over time; and one note on the international experience of intergovernmental settings in managing post-commodity boom. In addition, the Bank will launch work on the Fiscal Aspects of Oil Revenue Management in Iraq, possibly as part of the Country Economic Memorandum. This work will focus primarily on tools and policies to manage oil revenue volatility, including through an assessment of the relevance for Iraq of special fiscal institutions such as oil funds and fiscal rules. The goal is to help avoid “boom and bust” cycles in public spending as a result of oil revenue volatility.²⁰ Furthermore, in collaboration with the IMF, the Bank plans to work with the Government in the area of financial flows within the state-owned oil sector as part of the upcoming Public Expenditure Review exercise. A Fiscal Sustainability Assessment (FSA) is planned to be conducted in CY10 in collaboration with the IMF as part of the planned PER exercise.

134. **As noted in Section IV.D., the Bank is providing financial and technical assistance to Iraq on public financial management and the development of a National Poverty Reduction Strategy through two ITF-financed projects: the Public Financial Management (PFM) Reform project and the Household Survey and Policies for Poverty Reduction project.** The PFM project aims to improve allocation, execution, transparency and accountability in the mobilization and use of all public resources. Cross-cutting reform of the PFM will be addressed by the reform of the national PFM system, through strengthening budget formulation, execution and control, improving public financial reporting, strengthening public procurement and developing capacity in PFM, both at the central and the governorate levels. The project is supporting the implementation of the Government’s Public Finance Management Action Plan. The Household Survey and Policies for Poverty Reduction project aims to strengthen the ability of the Government to make informed policy decisions for poverty reduction, employment generation and safety nets. The project has financed a comprehensive household income and expenditure survey, data analysis and development of a Poverty Reduction Strategy. It also provided extensive capacity building to the Government in support of the data collection, data analysis and strategy development.

²⁰ The Bank’s dialogue with Iraq on oil revenue management issues is expected to intensify in the near future. Limited engagement in this area is the result of the political sensitivities associated with regional oil revenue sharing arrangements and the absence of a federal hydrocarbons law, restricting the scope for the provision of Bank’s inputs in this area.

Effectiveness of Public Spending in Line with the PRS

135. **Prior action 1: *The Ministry of Finance has adopted a framework for medium term budget strategy reflecting Government policy priorities and medium term macroeconomic and fiscal projections.*** The objective of this prior action is to improve the budget's alignment with Government priorities as a key to better budget implementation and, ultimately, service delivery. The budget is yet to become a true fiscal expression of the Government's long-term policy priorities. Spending units often build their budgets from the bottom-up, on the basis of long lists of poorly justified projects and with little regard to fiscal limits. Additional efforts are needed to place the budget within the context of robust medium term macro-economic analysis and fiscal framework. These shortcomings result in budgets which fall short on both quality and credibility.

136. **The Government has established a framework for medium-term budgeting, including a high level Government-wide Budget Strategy Committee.** The Committee is tasked with developing a medium-term fiscal framework, a multi-year budget strategy on the basis of Government priorities and sector strategies. The Committee produced the budget strategy for 2010-2013 in May 2009 with assistance from the World Bank. The Committee will continue its work in the upcoming 2011 budget cycle and will aim to produce a budget strategy which is more in tune with Government Priorities and Sector strategies. To this aim, the Committee will work towards closer harmonization with Government-wide and sectoral policy setting and planning. This measure will be complemented by the issuance of budget call circulars consistent with medium-term macroeconomic assumptions and fiscal forecasts.

137. **In February 2009, a Budget Strategy Committee for 2010-2012 was convened by the Ministry of Finance.** It included for the first time a broad cross section of stakeholders, including spending and revenue generating units, the Central Bank, the Council of Ministers Secretariat and the Finance Committee of the Council Ministers. Over two months the Committee, assisted by the World Bank, UK DfID and US Treasury, systematically reviewed existing and pending government policy documents such as the International Compact, the National Development Plan, Poverty Reduction Strategy, sector strategies and ministerial plans. The Committee also reviewed macro-economic analyses and fiscal projections carried out by the Ministries of Planning, Finance and Oil and the Central Bank.

138. **The Committee's work led to a workshop facilitated by the World Bank in May 23-24, 2009.** At the workshop, the various inputs were brought together to produce a Budget Strategy for 2010-2012 including a medium-term fiscal forecast and an Economic Essay. The workshop also discussed ways to further strengthen budget process and issues of sub-national fiscal relations. The resulting Budget Strategy was referred to a small Cabinet level committee which further sharpened its alignment with the Government priorities. The Budget Call Circular was then issued on June 1, 2009 accompanied by the Strategy, setting for the first time an overall expenditure envelope as well as individual Ministry ceilings.

139. **The resulting draft 2010 budget was submitted to the Council of Representatives on October 4, 2009.** For the first time, the draft budget was accompanied by an Economic Essay setting out the Macroeconomic and fiscal context.

140. **Prior action 2: *The National Poverty Reduction Strategy, which outlines public spending priorities in the social sectors, has been adopted by the Council of Ministers.*** Public expenditures over the past several decades have been poorly aligned with the long term development needs of the Iraqi population. From the 1980s onward, public expenditures have been focused on the military and universal consumption subsidies at the expense of the public services and infrastructure that would support productive activities of the population. The Poverty Reduction Strategy (PRS) is crucial to identify clear

priorities for spending allocation. In particular, the PRS articulates a clear change in spending priorities with an emphasis on enabling the poor to earn higher incomes from their labor, ultimately aiming at achieving a private sector-led, diversified economy.

141. **The PRS is the culmination of an intense program of activities by the Government of Iraq, supported by the World Bank.**²¹ This program of activities had three major components, all overseen by the Poverty Reduction Strategy High Committee.²² The first component responded to the absence of information on the living standards of the population by conducting the first national income and expenditure survey since 1988. The Iraq Household Socioeconomic Survey (IHSES) interviewed 18,000 in all parts of the country over a 12 month period, providing detailed indicators on employment, education, health, demographics as well as income and expenditures.²³ The second component of the program established an official poverty line and analyzed the causes and consequences of poverty.²⁴ Among other things, the analysis found that Iraq has the lowest employment-to-population ratio in the region. The third and final component of the program was the development of the Poverty Reduction Strategy itself. The PRS was developed using a Results-Based-Management approach and was firmly grounded in the poverty analysis.²⁵

142. **The PRS outlines the key public expenditure priorities needed to enable the poor to develop human capital and to generate income.** The strategy also outlines the reforms needed to provide a fiscally sustainable safety net for those who are unable to work.²⁶ At their November 24, 2009 meeting, the Council of Ministers formally adopted the Poverty Reduction Strategy and committed to its implementation. The prior action for this DPL – adoption of the Poverty Reduction Strategy by the Council of Ministers – will lead to the alignment between the priorities and the budget allocations. Already, the draft 2010 budget, with an increased share going to development of human capital, reflects a step in this direction. Progress on budget alignment will be monitored through annual PRS reports, prepared by a permanent institutional mechanism established for this purpose.²⁷ The World Bank will

²¹ The World Bank has been supporting the prioritization of public expenditures to serve the long term development needs of the Iraqi population through the Emergency Household Survey and Policies for Poverty Reduction project (HSPR). The HSPR project is comprised of two companion trust funds, financed by the Iraq Trust Fund: one government-executed and one Bank-executed. The Bank-executed component provided an intensive program of capacity building for the three components, including 44 workshops between 2006 and 2009. Prior to the signing of the grant agreement for the HSPR project an additional 9 workshops were held with support from the ITF-financed Second Capacity Building project.

²² The Poverty Reduction Strategy High Committee represents a broad range of Iraqi institutions including Parliament, the Prime Minister's office, key development ministries, the Kurdistan Regional Government and Iraq academia.

²³ In addition, the IHSES also provided the basis for a new Consumer Price Index and measures used in the National Accounts.

²⁴ The poverty line, developed by the PRS High Committee was adopted by the Council of Ministers in April, 2009. Using this poverty line, the analysis found that 23 percent of the population is poor, although most of these have consumption levels close to the poverty line. The Poverty Assessment also analyzed access to public services (e.g. education, health care, water and sanitation, electricity, agricultural infrastructure and safety nets) among various segments of the population. The poverty analysis culminated in a Poverty Assessment report, written jointly by the Poverty Reduction High Committee and the World Bank.

²⁵ The PRS benefitted from consultations with Iraqi and international stakeholders. In June 2009, the PRS High Committee held consultations with ministries, civil society, and the Iraqi private sector as well as the UN and several bilateral donors. Approximately, 120 people participated in the two-day event.

²⁶ The Poverty Reduction Strategy is comprised of six major outcomes: a higher income from work for the poor; improved health level of the poor; improved education level for the poor; better housing environment for the poor; effective social protection for the poor; and reduced inequality between poor men and women. Within each outcome, the PRS specifies outputs, the Governmental ministry of agency accountable for accomplishing each output, and activities. A matrix of the PRS outcomes, outputs and activities is attached as an appendix.

²⁷ The Council of Ministers, in their endorsement of the PRS, formed a High Steering Committee, chaired by the Deputy Prime Minister and comprised of the Ministers of Finance, Planning, Trade, Agriculture, Labor and Social Affairs, Education, Health, Reconstruction and Housing, and Women's Affairs. They also made the PRS High Committee a permanent body, to serve as the secretariat of the High Steering Committee. The strategy adopted in November is for the period 2010 to 2014 at which point a

continue to provide technical assistance for the implementation and monitoring of the PRS through the Emergency Household Survey and Policies for Poverty Reduction Project.

Public Financial Management

143. **Prior action 3: *The Shura Council has completed the review of the new procurement law in order to submit the bill to the Council of Ministers.*** The submission process for presenting procurement legislation to the Shura Council at the Ministry of Justice was launched in late 2008. Despite the extremely difficult circumstances and the bombings that targeted the Ministry of Justice, the Shura Council completed the review of the draft new law in November 2009. The new draft law will be submitted to the Council of Ministers for approval. Subject to the Council of Ministers' vetting, the new draft law will be presented to the Council of Representatives for a decision on enactment.

144. **Prior action 4: *The Ministry of Finance has issued a decree establishing a High Level Committee to develop the Manual for implementing the Chart of Accounts.*** The goal of this prior action is to ensure timely, accurate and informative financial reporting allowing for control, accountability and analysis. Iraq's legacy accounting framework is a hybrid of cash and accrual rules. The largely administrative classification is excessively detailed making it less conducive to analysis and monitoring. This is particularly the case for investments.

145. **A new Chart of Accounts was introduced in 2007 on the basis of Government Financial Statistic (GFS) classification.** Work to implement the Chart throughout public finances is ongoing. During the transition both the legacy and the new system continue to coexist with some agencies most notably the Supreme Board of Audit resisting the introduction of the GFS. As a result of these deficiencies, it has been difficult to ascertain on a timely and accurate basis the state of execution of the investment budget, as well as the level of outstanding commitments and cash balances. There have been significant delays in the production of final audited financial statements for the central government. These issues not only hamper accountability and control but they also frustrate efforts to improve budget execution by denying decision-makers access to actionable data.

146. **A decree was issued by the Ministry of Finance on October 10, 2009 establishing a High Level Committee to develop the Manual for the implementation of the Chart of Accounts.** The Committee is chaired by an official from the Council of Minister's Secretariat and includes representatives from the Ministry of Finance, Planning, Board of Supreme Board of Audit and spending units. The Committee is meeting regularly to prepare the Accounting Manual with support from the World Bank, IMF, DfID and U.S. Treasury. The most recent meeting was held in Beirut during October 17-24, 2009.

147. **The adoption of the Chart of Accounts will facilitate the introduction of commitment control and cash release systems and the gradual transition to a Single Treasury Account, envisioned under the PFMAP.** It is also a precondition for progress on the delayed Financial Management Information System. Clarifying and codifying the new Chart of Accounts and its rollout will also require capacity building to for both controllers and auditors.

new strategy will come into effect. In parallel with the PRS, the Government has been developing a National Development Plan, which focuses on investment over the coming five years. The two processes have been carefully coordinated with overlapping membership on the High Committees.

A.2. Reforming the financial sector

148. **This operation supports the Government of Iraq in implementing Phase I of the financial sector reform agenda, which focuses on restructuring the state-owned commercial banks, strengthening the regulatory and supervisory authority, and improving the financial institutional infrastructure.** These reforms aim to improving the performance of the financial sector, thereby helping Iraq develop private sector-led growth beyond the hydrocarbons sector, ultimately reducing its dependence on oil revenues. It comprises four policy areas: (i) financial restructuring of the Rasheed Bank and Rafidain Banks, improving their portfolio quality; (ii) institutional and operational restructuring of state-owned commercial banks; (iii) strengthening the supervisory and regulatory authority of the Central Bank of Iraq (CBI) to ensure full adherence to the Basel Core Principles; and (iv) operationalizing the real time gross settlement (RTGS) payments system, complying with international standards.

149. **The Bank has supported the Government in implementing banking sector reforms since 2004, through policy dialogue, analytical work, advisory services and technical assistance.** Together with the IMF, the Bank assisted the Government in the design of the terms of reference for the independent audits of the two state-owned commercial banks—Rafidain Bank and Rasheed Bank by an internationally reputable firm, Ernst and Young (E&Y), which was carried out and finalized in 2008.²⁸ Based on these audits and comprehensive due diligence, the Bank supported the Government of Iraq in developing the five-year Banking Reform Strategy (2008-2012), which was discussed in the previous section. This program addresses financial sector weaknesses with the objective of increasing private sector participation, promoting diversification of intermediaries and instruments, and strengthening the environment for resource mobilization, financial intermediation and risk management.

Restructuring the State-Owned Commercial Banks

150. **Prior Action 5: Settlement of at least 20 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007.** All the state-owned commercial banks were subject to independent financial due diligences as a prerequisite for financial restructuring. This due diligence focused on bank portfolio quality and on the analysis of distressed assets on a stand-alone and consolidated basis, and following International Financial Reporting Standards (IFRS). An assessment of the loan portfolio in the two state-owned commercial banks showed NPLs of ID 209 billion and ID 139 billion for Rafidain Bank and Rasheed Bank respectively. Following the recommendations of the audits, the Ministry of Finance, the owner of the state-owned banks, took the decision to clean-up the balance sheets of these banks. The objective of the financial restructuring of these banks is to restore their ability to comply with minimum capital adequacy and other prudential requirements of CBI, and to restore their full credibility with their business counterparts.

151. **Various steps were taken by the authorities to tackle the NPL issue.** A Financial Restructuring Committee has been formed to address the problem of NPLs. Decisions have been made with regard to the resolution of many NPLs. It is worth noting that recapitalization needs arising from NPLs are relatively modest despite the high share of NPLs (56 percent in value terms), because both banks' loan portfolios are very small. Over the past year, progress has been witnessed in the implementation of the audit recommendations, particularly regarding reduction of NPLs, and build-up in provision levels at state-owned commercial banks. This has been evident in the decline of NPLs by 20 percent on aggregate as of June 2007 (financial statements audited were those of 2007) in both banks, Rafidain Bank and Rasheed Bank to reach ID 165 billion and ID 110 billion respectively in December

²⁸ Based on the 2007 financial accounts.

2009. The Bank will monitor the process of recapitalization with the evolution of the capital adequacy ratio.

152. **The Government has decided that the banks need to sort out and reconcile assets and liability accounts, before they receive any new capital.** The state-owned banks have already begun the verification of their obligations toward foreign creditors under the Paris Club and the discussion of other, related issues with the Ministry of Finance. Rafidain Bank and Rasheed Bank are making appropriate accounting adjustments to their books. Such adjustments will be verified for accuracy by qualified, independent, external auditors. The necessary recapitalization will then go hand-in-hand with the progress on the operational restructuring. The settlement process of outstanding private claims as part of the liquidation of the London branch of Rafidain Bank is well underway and the process to liquidate fixed assets has begun and expected to conclude by end of 2009. The Government is well aware of the need to balance the objective of compliance with regulations and the risks of recapitalizing banks where operational and risk management processes are still being improved.

153. **Prior Action 6: *The Restructuring Oversight Committee (ROC²⁹) has endorsed the Banking Sector Reform Strategy and the Action Plan for the operational and institutional restructuring of the two state-owned commercial banks—Rafidain Bank and Rasheed Bank.*** One of the key measures this operation supports is the institutional and operational restructuring of the two state-owned commercial banks. The Bank has been providing technical support and guidance to the Iraqi authorities for the development of a comprehensive, action-specific for banking sector reform, which was endorsed by the Iraqi Authorities in February 2009. The strategy includes a detailed Action Plan, and is divided into two phases, identifying key starting points for various activities with clear timeline and benchmarks. As a result of the implementation of this comprehensive strategy, the state-owned commercial banks would adopt modern banking practices and systems. Implementation of the strategy will entail defining, in light of country circumstances, the mandate of the state-owned commercial banks with an initial focus on mobilization of savings and payments. Thus, the banks' activities are likely to be narrowly limited on deposit taking and payment transactions. As their capacity increases, they will move into other core banking operations including the extension of credit to the corporate and household sectors.

154. **The restructuring program also includes capacity building, aimed at developing the capacity of banks' branch staff to be able to handle basic deposit-taking transactions, using computers, and loan officers' capacity to assess credit risks.** Another key element of this reform process is the development of risk management, including: support to the establishment of a well-functioning, adequately managed and completely staffed risk management organization in line with international and regional best practices; changes in the organizational structure, especially the set up of a risk control department; and development of manuals for risk management. There have also been some developments in the implementation of the banking reform program. Considerable progress has taken place in the institutional, operational and financial restructuring of the two state-owned banks—Rasheed Bank and Rafidain Bank.

²⁹ The Restructuring Oversight Committee (ROC) is in charge of the restructuring and reinforcing of reforms in the banking sector in Iraq, as well as designing the strategy and setting the vision for a sound and inclusive financial system. This is a high-level decision making body that is chaired by the Governor of the Central Bank of Iraq (CBI), in his capacity as the regulator and supervisor; comprising the Minister of Finance, in his capacity as the owner; and the Chairman of the Board of Supreme Audit. The main priority on their reform agenda over the past few years was the restructuring of the state-owned commercial banks. Key decisions made by ROC are transmitted through the Executive Steering Committee (ESC), which is in charge of the day-to-day implementation of the restructuring program. ESC is chaired by the Deputy Governor of CBI, and comprising high-level representatives from the Ministry of Finance, and the Board of Supreme Audit; as well as two CBI technical experts.

Strengthening the Regulatory and Supervisory Authority

155. **Prior Action 7: CBI has approved its new organizational chart and a detailed program for capacity building in banking regulation and supervision.** This prior action aims to support continued strengthening of legal, regulatory and supervisory capacity in banking. CBI needs to implement the corrective actions required to close the gap between existing practices at CBI and international accepted best practices. Under the Banking Sector Reform project, the Bank is supporting capacity building for CBI to enhance its supervisory and regulatory functions. Support includes reviewing the existing banking supervision process, assessing the effectiveness of CBI's supervisory apparatus to the adherence to international codes and standards, and preparing a detailed action plan to address any deficiency, gaps and needs in coordination with the IMF. Capacity building and training of the staff of the supervision department at CBI would also include setting up the underpinnings of a strengthened regulatory and supervisory framework, focusing on on-site and off-site processes. CBI is currently working on carrying out an in-depth assessment of banking supervision authority, with the support of the World Bank, IMF, and US.

156. **The first phase of capacity building for a strengthened supervisory framework, which started in June 2006, is well under way and focused *inter alia* on developing and implementing appropriate supervisory tools and methodologies to implement the move from compliance to a more proactive and modern risk-based supervision.** *On-Site Inspection is focusing on risks.* Increased attention has been directed to credit organization and policy, concentration of credit, risk management system, IT system and internal controls. As a result, a new assessment approach for on-site supervision has been developed with inspection teams updating the On-going Surveillance database with the data collected in the field. Once in effect, this type of feedback will help strengthen and improve the On-Going Surveillance reports credit institutions along a CAMELS (Capital Assets Management Earnings Liquidity Sensitivity) based approach. Finally, a closer cooperation between On-Site and On-Going Surveillance has been taking place, especially regarding the elaboration of the corrective actions.

157. **The On-Going Surveillance framework has developed new tools to help focus on critical issues for an enhanced decision making process.** A draft risk-oriented report regarding the strategy and the overall performance of a credit institution has recently been issued to the top management of the CBI. This report produced, on the basis of the CAMELS-type approach, constitutes a comprehensive review of the banks. Produced on an annual basis, these reports will cover all risks inherent in the bank's activities, including both quantitative and qualitative information. In a nutshell, this annual report is designed to convey the banks' overall risk profile. The On-Going Surveillance new framework could, in the long run, help the CBI develop an Early Warning System enabling an adequate, proactive framework to deal with problem banks. In particular, it should help the CBI in determining the levels of capital ratios as well as best suited remedial measures to address particular events or risk profile of credit institutions.

Improving the Financial Institutional Infrastructure

158. **Prior Action 8: CBI has introduced a real time gross settlement (RTGS) payments system complying with international standards.** A key pillar of financial sector reform in Iraq is improving the financial institutional infrastructure. The structure and efficiency of the banking and financial system is greatly shaped by the nature of its institutional infrastructure, which includes information exchange setup; payments system; financial reporting; and accounting standards. Although the Iraqi authorities are making efforts to improve the institutional framework, there still remain large gaps. Moreover, much of what is there remains untested and not all of it is conducive to easy access to financial services. An

adequate and supportive institutional infrastructure is essential. The CBI is leading efforts to create a modern payments-systems infrastructure covering systems operations, policies and regulations, and payment-system oversight. The implementation of the RTGS system would reduce the total processing time of checks inside CBI significantly. The state-owned commercial banks are currently working on the introduction of the RTGS system in the Iraqi market, in collaboration with development partners.

A.3. Improving the efficiency of the social protection system

159. **The recent Council of Ministers' decision regarding expenditure prioritization reflects a key shift from an emphasis on subsidizing consumption towards enabling the population to earn higher incomes from their labor, in the context of a private sector-led, diversified economy.** At the same time, the Government of Iraq recognizes that there are some segments of the population that are unable to earn even a minimal income from their labor – due to disability, temporary unemployment, old age or other reasons. Acknowledging this reality means that a system of social protection is an essential part of the expenditure strategy.

160. **This pillar of the DPL program would help the Government of Iraq move towards a more efficient and fiscally sustainable social protection system as well as better mitigating the impacts of fluctuations in oil revenues.** It comprises three areas of social protection: rationalization of the PDS, strengthening of the Social Safety Net (SSN), and strengthening the retirement pension system.

Rationalization of the PDS

161. **Prior action 9: The Council of Ministers Secretariat has established a High Committee mandated to propose a time-bound action plan for rationalization of the Public Distribution System (PDS).** Currently, the Iraqi safety net is comprised of two major programs. By far the larger of these programs is the Public Distribution System, which provides a fixed basket of commodities to nearly every Iraqi citizen on a monthly basis.³⁰ The PDS is a very large program – absorbing 8 percent of total Government spending in 2008 (compared to 6.2 percent spent on education or the 4.7 percent spent on health in the same year). It provides 85 percent of required calories and reaches 99 percent of the population. Although effective as a safety net, the PDS is enormously inefficient. Three aspects of inefficiency are particularly noteworthy: (i) the PDS is provided to wealthy households as well as poor households; (ii) management of the PDS is rudimentary, making it vulnerable to waste, theft and corruption; and (iii) the PDS's heavy reliance on state-owned-enterprises and non-competitive procurement³¹ crowds out the private sector and reduces the gains in efficiency associated with competition.³² The second, and smaller of the two safety nets is a cash transfer program managed by the Ministry of Labor and Social Affairs (MOLSA), referred to as the Social Safety Net (SSN). The SSN provides beneficiaries with transfers about the same size as the PDS. However, it reaches a much smaller

³⁰ The PDS was introduced in 1991 in response to the declining availability of food imports under the UN sanctions and played a crucial role during that period, helping to avoid a humanitarian crisis.

³¹ The Ministry of Trade operates the PDS in close co-operation with three principal State-Owned-Enterprises: the State Company for Grain Trading, the State Company for Grain Processing, and the State Company for Foodstuff Trading. In addition the Ministry of Transport supports distribution through the State Transport Company. Procurement practices lack transparency and do not ensure value for money, and contribute substantially to delays and prices that are considerably above world market prices.

³² Preliminary calculations suggest that it costs more than \$6 to transfer \$1 worth of benefits to a poor person. Analysis of the inefficiency due to lack of targeting was conducted by the World Bank and Food Ration Reform High Committee. A summary of this analysis is presented in Annex 4.

portion of the population. The reforms related to this program will be elaborated in the next prior action below.

162. Although the problems with the PDS have been acknowledged for several years, until very recently there was no agreement on the segment of the population to be targeted and the information needed to perform targeting or assess the quality of targeting was not available.³³

Significant progress has been made over the past three years on both of these constraints, with support from the World Bank and other donor institutions, and the prerequisites for reform are now in place. The Iraq Household Socioeconomic Survey, conducted in 2007, provided the data needed to define a poverty line and to assess the quality of targeting of existing programs. An official poverty line was developed by the Poverty Reduction Strategy High Committee and adopted by the Council of Ministers in April, 2009. In June 2009, a High Committee was formed by official decree, mandated to propose a time-bound action plan for the rationalization of the PDS.³⁴ With support by the World Bank, the Food Ration Reform High Committee has developed a set of recommendations for gradually introduce targeting (including exclusion criteria for each phase); a reduced number of products to be included in the basket; and improvements in the management of the PDS.

163. A crucial achievement was made on November 24, 2009 when the Council of Ministers made two major policy decisions related to the PDS and the SSN. The first major policy decision was that the PDS would no longer be provided to the entire population, but rather would be available for a limited segment of the Iraqi people, implying a substantial reduction in the budgetary allocation required by the PDS once the reform is fully implemented. The second major policy decision was that targeting of the PDS and SSN would be aligned with the official poverty line through the development of an improved targeting tool to identify the poor. This achievement was the result of the work of two Iraqi High Committees working in parallel but with close coordination: the Poverty Reduction Strategy High Committee (see prior action 2) and the Food Ration Reform High Committee.

164. The establishment of the Food Ration Reform High Committee is included as prior action in this DPL because it is an essential step towards a more effective, efficient and fiscally sustainable system of safety net programs. In the shorter term, the DPL will support the following two program outcomes: First, rationalization of PDS will be initiated through elimination of high income civil servants (as well as other high income groups), from PDS eligibility. Second, a public information campaign will be launched to announce PDS targeting and explain the process and timeline for this transition.³⁵

³³ Because of the large size of the transfers and the dominance the PDS has in the market for relevant commodities, a sudden withdrawal of the PDS would result in a large increase in poverty as a result of both the direct elimination of transfers and as a result of the increases in prices as the supply is shrunk. (See analysis in Annex 4). Any reform of the PDS, therefore, must be done gradually and carefully monitored. In addition to the absence of agreement within the Government on a reform direction and the lack of data needed for targeting, until recently the security situation and soaring public revenues made any reduction in benefits politically difficult.

³⁴ The Food Ration Reform High Committee is chaired by the Secretary General of the Council of Ministers and includes Undersecretaries from the Ministries of Finance, Planning, Trade, Labor and Social Affairs, Deputy Governors of Baghdad, Al Anbar and Babil, representatives from the Kurdistan Regional Government and Iraqi Parliamentarians.

³⁵ The Food Ration Reform High Committee has already drafted a time bound action plan for targeting. This action plan starts by excluding high income civil servants (as well as specific categories of other high income individuals working in the private sector) from PDS eligibility. Although the fiscal impact of the first step in targeting will be relatively small, it provides an opportunity to explain the concept of targeting to the general population through a public information campaign, demonstrating that government officials are willing to be the first to forgo the food ration benefits. World Bank technical assistance will include support for the targeting of the PDS and for the development of public information campaigns.

Strengthening the Social Safety Net

165. **Prior Action 10: *The Council of Ministers has endorsed a policy of reforming the Social Safety Net through improved targeting methods.*** The objective of this policy action is to enhance the Social Safety Net program operated by MOLSA through better targeting of poor and vulnerable households. As the envisaged rationalization of the PDS moves forward, the Social Safety Net program will need to be more effective and efficient in targeting poor and vulnerable households. This will mean shifting the method of targeting gradually away from the current categorical targeting of certain groups, to a more robust method that minimizes leakage and exclusion of the poor from the program. Methods of targeting that are based on proxy-means testing (PMT) will be explored. Objective tools such as PMT employ observable household indicators (such as household assets, socio-economic characteristics, and housing characteristics) to predict income levels; which can also be combined with geographic targeting (this method bases targeting on where the household lives). The current categorical targeting that is used by the Social Safety Net program reaches less than 10 percent of the poor. Furthermore, there are poor governorates like Muthana with nearly 50 percent of its population below the poverty line but where only 3 percent of the households receive the cash transfer. There are enormous benefits to improving the targeting of the program and this prior action is the first important step towards making the Social Safety Net program more effective.

166. **MOLSA has also made progress in increasing its capacity to manage the Social Safety Net program.** Through the ongoing Emergency Social Protection Project (ESPP), financed by the Iraq Trust Fund, and through support from USAID, MOLSA has been undertaking capacity building in two key areas: (i) Developing human resources to manage the Social Safety Net program; and (ii) building the systems needed to capture beneficiaries in a database and to streamline the application process through the use of information systems. MOLSA staff have received extensive training in administrative, managerial, and technical areas related to the Social Safety Net program, either from the ESPP or from USAID. In addition, MOLSA has established the infrastructure to support application processing in all governorates, as well as to facilitate the approval and decision making process. Finally, the cash delivery mechanism is also currently served through local post offices, and a pilot using smartcards for payment is underway. The National Social Safety Net information system, which is designed to electronically capture beneficiary information, was launched by the Minister of Labor and Social Affairs in end-May 2009.

167. **In the medium term, MOLSA will develop the new targeting tools, using data from the household survey, and to pilot both the tool and the full implementation process.** With the policy decision made to enhance the Social Safety Net program through improved targeting methods, the next steps are for MOLSA to continue the process of capacity building and systems improvements, and to move towards building the new and improved targeting tool (which may include a combination of proxy-means testing and geographical targeting tools as indicated earlier). The process will proceed along two stages. Stage 1 will design the targeting tools and prepare for the pilot; and Stage 2 will pilot and calibrate the new mechanism, to test the application and benefit distribution, and to evaluate the poverty impact of the new targeting tools. The World Bank, through ongoing and proposed projects, will provide support to MOLSA throughout this process.

Strengthening the Retirement Pension System

168. **Prior Action 11. *The management and governance structure of the State Pension Fund (SPF) has been put in place through (i) approval of the executive regulations and by-laws of the SPF by Council of Ministers; (ii) appointment of the General Manager of the SPF by the Prime Minister; and***

(iii) appointment of the Board of Directors of the SPF by the Minister of Finance. The objective of this policy action to have the structures needed to manage the pension contributions of the SPF. The State Pension Fund is the administrative unit within the unifying umbrella of the National Board of Pensions (NBP) which will receive all collected pension contribution, and is the source of payment for pension benefits. The SPF has been accumulating reserves since the enactment of the Unified Pension Law. The establishment of the management and governance structure will allow the SPF to be administered effectively, moving towards prudent management and investment of the accumulated reserves in the fund, while maintaining the ability to adequately meet future liabilities of the pension system.

169. **The Unified Pension Law was enacted in December 2007 to modernize the pension system in Iraq and bring it in alignment with international best practices, and implementation of the law has commenced.** In particular, the NBP has been established as the unifying body of the mandatory pension schemes, and the Chairman of the NBP appointed. The NBP absorbs the Pension Directorate of the Ministry of Finance, which used to administer the old State Pension System. Furthermore, the Unified Pension Law requires that the existing Social Security System and the private sector pension scheme, to be transferred under the authority of the NBP. The envisioned merger is desirable as much as it alleviates the segmentation of the labor market along the public/private divide. A Pension Reform Management Office has been established under the NBP and is charged with coordinating the implementation of pension reforms.

170. **In the medium-term, the NBP is expected to initiate the data collection for the actuarial analysis of the public pension scheme.** The actuarial analysis is prescribed in the law, and is required to (i) assess the fiscal sustainability of the SPF; (ii) initiate policy measures, if required, to achieve financial equilibrium for the fund. In addition, the NBP will continue to develop the pension administration processes and systems, as well as develop the investment management policies of the SPF through support from the World Bank PRISTA project.

C. Program Features, Loan Amount and Tranching

171. This proposed DPL is the first of a programmatic series of two DPLs of US\$250 million each, totaling US\$500 million. The loan will be denominated in US dollars at a fixed spread with a total repayment term including grace period of 15 years (with a grace period of 4.5 years). The Front-End Fee would be financed out of the loan proceeds (capitalized).

VI. OPERATION IMPLEMENTATION

A. Consultations and Distributional Aspects

172. **In line with OP 8.60, the Bank advised the Iraqi authorities on the need to undertake consultations on the reform program with the various stakeholders, such as Parliamentarians, private sector, and civil society.** The authorities confirmed that the Iraqi Government been conducting consultations over the last year with the various stakeholders, and that they will be providing the Bank team with all the supporting documentation in that regard. They also indicated that further consultations on the reform program underpinning this proposed operation will take place in the coming period. The Bank has also highlighted to the Iraqi authorities the importance of the consultation and participation process, which is key to sustainability, and enhancing the program's development outcomes. The Government intends to conduct further consultations with key stakeholders on the reform program underlying this DPL, in line with OP 8.60 and MNA Region's Management Action Plan, and Region's

policy and practices for stakeholders' participation, including through disclosure, translation of program documents, and outreach.

173. **A consultation meeting with the donor community on the DPL was organized by the Ministry of Finance in Baghdad in October 2009.** The meeting was chaired by the Ministry of Finance, and was attended by Representatives from the United States, Japan, Italy, United Kingdom, Denmark, Australia, United Nations, European Commission, and World Bank. Overall, there was strong donor support for a substantial budget support to Iraq through the proposed DPL. The donors stressed the need for additional World Bank financing above and beyond the US\$500 million envelope provided for investment lending under the Interim Strategy Note (ISN). They welcomed the proposed prior-action reforms of the DPL, particularly in the area of public finance management (PFM). The Government intends to hold further consultations specific to the program supported by this DPL, with civil society groups.

174. **Consultations on key aspects of Iraq's reform program supported by the Bank were conducted with key stakeholders throughout the process of preparing the ISN for Iraq for 2009-2011.** The ISN consultations were held with civil society and private sector representatives, the donor community, and Government officials, including representatives of line ministries and the High Committee for Poverty Reduction. The content of this DPL is fully aligned with the ISN.

175. **Whereas PRSs which are used for debt relief are required to hold consultations, the Iraq PRS was undertaken at the Government's initiative and had no such requirements – nonetheless, the PRSHC held consultations on the proposed strategy.** The PRS was developed with the intense and active participation of the High Committee representatives from the Prime Minister's office, the Ministries of Planning, Finance, Education, Health, Trade, Women's Affairs, Justice, Labor and Social Affairs, the Kurdistan Regional Government, Parliament and academia. The entire PRS High Committee participated in a series of 13 workshops in addition to numerous meetings in Baghdad. In June 2009, the PRSHC held consultations with other ministries, civil society, and the Iraqi private sector as well as the UN and several bilateral donors. Approximately 120 people participated in the two day event.

176. **The Bank has been informed that Trade Unions were consulted by the Government for the revised Unified Pension Law.** The Bank had discussions with Iraqi Trade Unions in September 2009 during which the unions raised concerns over social protection and pensions. Though this discussion was not specific to the DPL instrument, the Bank has the beginnings of a dialogue with the unions, and has encouraged the Government to consult with them and other civil society stakeholders on the reform agenda. During supervision of this operation, we will also encourage government to consult with civil society groups on key policy reforms.

177. **It should be stressed that it is considerably more difficult than the typical country context to consult with organized groups on policy reform in Iraq given its conflict-affected status.** This is due to the nascent organization of civil society and other stakeholder groups, as well as difficulty in movement and conducting large group meetings in Iraq given the current security situation.

178. **Going forward, Iraq will continue with the process of reconstructing both physically and institutionally after years of wars, sanctions and mismanagement.** The experience with regards to conflict-affected countries shows that economic recovery – especially employment – is a key factor in avoiding recurrence of conflict. The literature also shows that capacity to do reconstruction develops gradually such that governments are able to make best use of reconstruction financing only several years after the end of the conflict. The lesson here is that Iraq is only now hitting its stride in terms of capacity

and its ability to make good use of financing and that halting its reconstruction could contribute to political instability. The literature also shows that the post-conflict environment often provides a key opportunity not only for physical reconstruction but also policy reform.

179. **In addition to consultation issues, it should be noted that the following social welfare and distributional considerations are of particular relevance to the present loan³⁶:**

- **Pillar 1:** Iraq is resource-rich country, and the population can enjoy the full benefits of those resources with an improved public financial management. The Government is working on better prioritization of its spending through improvement in of information collection and enhancing its capacity to plan. In the education sector, for example, there have been efforts to reduce disparities in resource allocation among the governorates, through the increase in investments in these areas. Moreover, inadequate procurement, cash management and control and accounting systems have left public resources vulnerable to waste, theft and corruption, detracting from the Government's ability to deliver services to the population. Improved effectiveness of public expenditures in line with the Poverty Reduction Strategy, and improved management and transparency will mean that more resources get to benefit the people.
- **Pillar 2:** There is a large body of research showing that a well-functioning financial system is linked to growth and poverty reduction. The population lacks access to finance. Although the volume of bank lending is growing, it is very low. Domestic credit is only 2.6 percent of GDP. Private sector investment is nearly all from personal savings and credit to the private sector is largely through translations among individuals. The population is therefore expected to benefit directly from the financial system reforms. Given that Iraq's financial system is dominated by state-owned banks, these reforms would also help reduce the budgetary drain that these loss-making banks currently generate, potentially creating fiscal savings for more productive expenditures. In addition, since the budget is implemented through these banks, reforms aimed at increasing their efficiency would also support higher efficiency of public spending. Finally, financial system reforms are key to private sector development, which is expected to be the engine of employment growth in the coming period.
- **Pillar 3:** Iraq spends a significant portion of its budget on social protection, yet the impact of such spending needs to be improved. The food ration system is effective as a safety net, reaching nearly all poor Iraqis. However, it is inefficient because it is universal, is poorly managed, and distorts the private sector. A second, targeted cash-based safety net is also in place, managed by MOLSA. The MOLSA safety net has the potential to be a far more efficient safety net because it is targeted, but the mechanism for targeting needs work if it is to reach a significant share of the poor and avoid leakage. The rationalization of the PDS and the enhancement of the MOLSA safety net are essential both fiscally and in order to protect the poor and vulnerable from a wide array of shocks. In addition to the safety nets, the pension system is a key part of the Government's social protection system. As with the safety nets, reform of the pension system is essential to guarantee fiscal sustainability and to ensure old-age income.

³⁶ A Poverty and Social Impact Analysis of the rationalization of the Public Distribution System is presented in Annex 4.

B. Environmental Aspects

180. **This operation is a development policy loan in support of a program of reforms for which the environmental requirements of OP/BP8.60 apply.** The proposed DPL is not expected to have significant effects on the country's environment, forests and other natural resources. The environmental and natural resource implications are driven to a large extent by the nature of an operation. In the proposed operation, none of the prior actions as listed in the policy matrix is expected to have environmental impacts or risks.

C. Implementation, Monitoring and Evaluation

181. **The responsibility for implementing the program in Government rests with the Ministry of Finance (MoF). The MoF is responsible for the implementation of the DPL as well as for coordinating the actions among the concerned institutions** (including Ministry of Planning and Development Cooperation, Central Bank of Iraq, and the Ministry of Labor and Social Affairs). Together with the MoF, these institutions will collect the necessary data for the identified monitoring indicators. The MoF and the Bank have agreed to monitor the progress in the program supported by the DPL and its evaluation will serve to inform preparation of a next Bank assistance strategy for Iraq, succeeding the current ISN.

182. **The multi-sector nature of this operation requires inter-agency coordination to ensure successful implementation.** Inter-agency institutional arrangements are thus needed to prepare, oversee and monitor reform program.

D. Fiduciary Aspects

183. **The Government has launched several actions to improve the management of the public funds particularly since 2006**, through the International Compact with Iraq³⁷, and Iraq has committed to implement specific PFM measures with the active support of donors throughout the past few years. This is done to mitigate the fiduciary risks in the public sector in Iraq which are considered to be high given the weak control environment and difficult security situation. This is the general conclusion of a number of studies, including the 2008 World Bank-led PEIA and financial management accountability assessment reports issued respectively in 2007 and 2009³⁸, as well as other reports issued by IMF and other donors.³⁹

³⁷ Under the International Compact, launched in 2006, the Iraqi Government committed to align its public finance management system with international standards. More specifically, it committed to introduce a single treasury account; increase budget coverage and transparency also to include donor-financed expenditures; establish a Medium-Term Fiscal Framework (MTFF) and credible reporting practices, including through the full implementation of IFMIS; bring budget execution and public procurement procedures in line with internationally accepted practices; and perform regular audits of government accounts.

³⁸ Financial Management Accountability Assessment Report issued on June 2007 and Report on the Assessment Fiduciary Risk in Iraq issued in November 2009. The IAMB DFI Management Letter on Spending Ministries contains 536 observations of control weakness.

³⁹ List of reports includes: The World Bank, *Financial Management Accountability Assessment*, January 3, 2007, The World Bank, *Iraq Trust Fund Report to Donors*, October 2007, The World Bank, *Iraq, Subnational Public Financial Management: A Diagnostic Report*, November 26, 2007, The World Bank, *Public Expenditure and Institutional Assessment* (2 volumes, including PEFA assessment), June 2008, The World Bank, *Aide-Memoire, Pre-Appraisal Mission, Proposed Public Financial Management Project*, Amman, Jordan, June 14-20, 2008; The World Bank, *Emergency Project Paper for a proposed grant in the amount of US \$18.0 million from the Iraq Trust Fund to the Republic of Iraq for the Public Finance Management Project*, February 5, 2009; The International Monetary Fund, Fiscal Affairs Department, *Iraq, Reform Priorities in Public Financial Management*, July 2008; The World Bank, *Interim Strategy Note for the Republic of Iraq for the period MID FY09-FY11*, February 19, 2009. Office of the Special Inspector General for Iraq Reconstruction, *Interim Report on efforts and Further Actions*

184. **The Iraqi authorities are working on strengthening the PFM system to address weaknesses in Governance.** The systemic weaknesses are noted in every aspect of public sector financial management. These range from the budgeting processes to the Treasury and flow of funds, accounting, reporting, internal controls and auditing processes. Fiduciary risks at each of these areas are considered high and particularly aggravated by the difficult security situation. A detailed Fiduciary Risk Assessment of the PFM was completed in November 2009 which highlighted the risk level that is likely to remain so until the ongoing capacity development programs are fully implemented.

185. **The Government has made efforts over the past few years to address problems in budget management, such as the introduction of GFS-based economic classification.** The implementation of the GFS-based classification is still in early stages. The budget still lacks full credibility (with aggregate expenditures exceeding budgets by more than 15 percent over the past 3 years); in addition to the accumulation of arrears. The system is also characterized by the maintenance of extra budgetary funds, contingent liabilities and other quasi-fiscal activities.

186. *Treasury and flow of funds.* The authorities are aware of weaknesses in the control framework, particularly in cash management. Accordingly, the Government is working on improving the cash management system in order to facilitate the flow of funds to speed up the budget execution, particularly the investment budget. The cash forecasting was assessed by the PEIA to be incomplete, with irregular updates, leading to the absence of an overall sound cash management and forecasting function. The PEIA did not find direct evidence of misappropriations of cash, but reported on anecdotal reports of unreported and unremitted government revenues. The predictability in the availability of cash is particularly compromised by the absence of control over commitments.

187. *Accounting and reporting.* The complementary Chart of Accounts to the new GFS-compliant economic classification system has been introduced. The reconciliation of bank accounts was still found to be irregular. In-year budget execution reports are produced, but comparisons with the budget can only be done at the payment stage. Quarterly reports are more sound than the monthly reports, but further improvement is needed in terms of timeliness and reliability of data. The same applies to the annual accounts. The budget execution accounts for 2008 are currently being finalized. On reporting, BearingPoint was rehired recently by USAID to finalize the IFMIS project, and substantial resources have been allocated. However, the new system is not yet operational and the Government still relies on legacy systems. Progress on IFMIS is crucial, given its centrality to a well-functioning PFM system.

188. *Internal controls and internal audit.* The International Compact – set out to strengthen internal controls, internal audit, and mitigate corruption – contributed to some improvements between 2005 and 2008 but more needs to happen to reach the defined objectives of transparency. The 2008 PEFA indicators under the PEIA for this area covered: payroll controls; procurement controls; controls for other expenditure and internal audit. It concluded that all these areas will still need significant improvements.

189. *External audit.* The BSA has been aware of the need to upgrade standards and working methods, through a re-engagement with the international community. Since 2005, it entered into twinning arrangement with the UK National Audit Office (NAO) and received strong donor support to: modernize audit methods; strengthen capacity to perform the audit of annual accounts; and develop tools to better detect fraud and corruption. The last audit of the Government of Iraq accounts by the BSA to be finalized was for the year ended December 31, 2005. In 2008, the PEIA confirmed the 2005 assessment of the

needed to Implement a IFMIS in Iraq, October 24, 2007; USAID, *Iraq Financial Management Information System Situation Assessment*, January 20, 2009; *The Global Integrity Report* and *Global Integrity Index*, 2008.

BSA's audit scope as adequate and identified areas for improvement including the timely submission of annual reports to the Council of Representatives (CoR).

190. **Various initiatives to reform the PFM system, increase transparency and accountability are underway though encountering difficulties.** As noted earlier, the Government is aware of the above weaknesses and the risks entailed. The authorities have been working with various donor partners to make progress in these areas and address the deficiencies. Key PFM initiatives include:

- The introduction of the IFMIS, although implementation has been slow;
- The enactment of the Financial Management Law, which provides the basis for the establishment of rules and regulations to govern the public financial management in the country and set the adequate control framework in the areas of budget preparation and management, treasury management, accounting and external audit.
- An ITF-funded PFM reform project (effective since July 20, 2009) and aiming at strengthening budget preparation and management, public financial reporting and control, procurement, and capacity development; and
- Strong donor support to the Board of Supreme Audit (BSA).

191. **These reforms represent work in progress, requiring long-term efforts to yield the expected results and eventually lessen the level of fiduciary risks associated with the use of public funds.** Some of the reforms are more advanced than others. Some have experienced difficulties and came to a halt such as, the IFMIS, funded and led by the USAID. Such a situation calls for a continuous dialogue between donors and the authorities and a renewed commitment on the part of the Government. This was the case during the discussions of this operation between the Government and the Bank with the participation of IMF. The agreed prior actions in the policy matrix translate such a renewed commitment. With regard to advancing the reforms in the areas of accounting, a prior action has been discussed and agreed to further the implementation of the Chart of Accounts (COA), through the establishment of a High level Committee that will be responsible to launch and oversee this process. The prior action aims at getting the process started in 2009, through in particular the issuance of a Ministerial Decree establishing a High Level Committee to oversee the implementation of the Chart of Accounts.

192. **Going forward, further efforts are also needed to issue the 2006, 2007 and 2008 audits of the Government accounts by the Board of Supreme Audit (BSA); and the implementation of the IFMIS.** It is important to note that some of the work in these areas has been reported to be at an advanced stage. Audits of 2006 and 2007 accounts are expected to be issued soon by the Board of Supreme Audit (BSA), while the 2008 Government accounts are being finalized by the government and will be sent to the BSA in the next months. Similarly, progress on the Government Integrated Financial Management System (IFMIS) is important to ensure timely reporting and transparency of public accounts. It will also be very important to advance the reforms in the other areas of internal controls and audits to ensure proper checks and balances. These are areas that will need to be followed up as part of the continuing dialogue between the Bank and the Iraqi Government, and as part of the Bank supported Public Financial Management project.

193. **The Bank is also in discussions with the BSA to implement a TA program under the ITF.** The support would include: pursuing greater independence, developing professional capacity and ensuring convergence with International Government Standards on Auditing. Coordination with other donors supporting the BSA is key.

194. **The fiduciary risks cannot be mitigated for this DPL.** The Bank, however, will require the opening of a designated account in US Dollars for the proceeds of the loan at CBI and the requirement of the audit of the designated account according to Terms of Reference and auditors acceptable to the Bank to ensure that the funds are included in the budget financial records.

195. **Possible mitigating measures were considered and not retained.** The project team considered the use of a positive list of items to finance using the loan proceeds. It was concluded that while such a list could not mitigate any of the fiduciary risks related to internal control weaknesses; and it may create reputational risks to the Bank. As such, the positive list was deemed not appropriate for the case of Iraq at the current time.

E. Foreign Exchange Environment, Disbursements and Audit

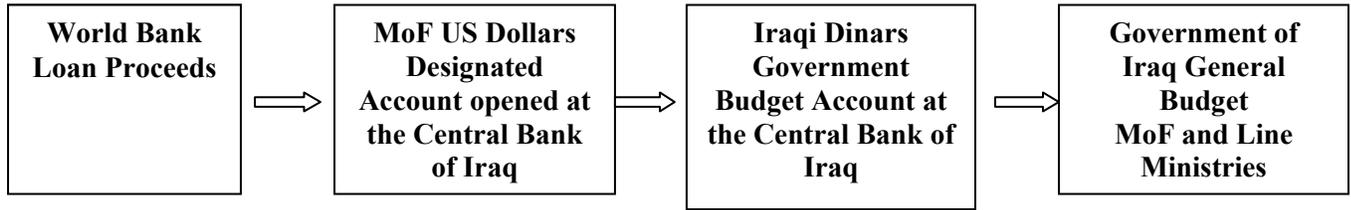
196. **Foreign Exchange Environment and Central Bank.** The IMF assessment of the CBI is showing important weaknesses of the control environment over the foreign exchange and identified structural safeguards risks. These weaknesses are particularly noted in the accounting and control areas as reported, also, by previous independent audits of the CBI for the years 2005 and 2006. The audit opinions were issued with qualifications due to scope limitation and weak controls over accounting procedures. The IMF assessment concluded that the CBI operating environment requires important modernization and that the CBI has already engaged towards important steps to strengthen its safeguards framework. IMF is in dialogue with the CBI authorities on these steps and is monitoring their progress. An audit of the CBI accounts for 2008 is underway.

197. **Additional research from various audit reports, published by the International Advisory and Monitoring Board of Development Fund for Iraq, have reported continuously on a number of weaknesses in the CBI control environment and the risks involved.** The capacity building actions proposed under this operation as well as by the ITF-financed project for the financial sector are partially oriented towards the strengthening of the CBI control environment.

198. **Flow of Funds.** The proposed loan will follow the Bank's disbursement procedures for development policy support. Once the loan is approved by the World Bank's Board and becomes effective, the proceeds of the loan will be disbursed in one tranche following effectiveness of the DPL.

199. **The flow of funds for this operation is subject to regular DPL arrangements and standard public financial management processes.** As the loan proceeds will be deposited into the government budget account in local currency, it will be not possible to track the ultimate use of the funds provided under the DPL. However, the proceeds of the loan will flow, through the CBI, into a US Dollars Designated Account to be opened by the MoF at the CBI and which will be used solely for the loan proceeds. The CBI, acting on MoF instructions, will then credit an equivalent amount, in Iraqi Dinars, to the Government of Iraq general budget account at the CBI. The MoF will then furnish to the Bank a confirmation of this transfer: advising that the total sum of the loan has been received. When deposited into the government budget account, the loan proceeds will then be subject to standard public financial management processes and procedures. The total amount of time between disbursement by the World Bank of the loan proceeds in US\$ and the credit into the MoF's Iraqi Dinars account should not exceed 15 days.

Figure 5. Flow of Funds



200. **Audit of the Loan proceeds.** The Government will appoint an independent auditor, acceptable to the Bank to conduct a special purpose audit of the Designated Account opened at the CBI for the loan proceeds. The audit will be conducted according to terms of reference acceptable to the Bank and the audit report should be submitted to the Bank no later than 4 months from the deposit by the Bank of the Loan proceeds to the CBI account.

F. Value-Added and Benefits

201. **The value-added of the proposed DPL vis-à-vis existing operations being implemented in Iraq include:** (i) bringing together for the first time different strands of Bank assistance under a consolidated, coherent reform package; (ii) proposing prior actions and future reforms in areas not directly addressed in previous operations, such as the linkage between Iraq's Poverty Reduction Strategy and the Government budget as well as the rationalization of the PDS; and (iii) accelerating the policy decisions on a number of reform areas, thereby energizing the reform agenda and providing key synergies with the implementation of the investment project portfolio.

202. In addition, the proposed program includes the following main benefits:

- **Providing urgent financial resources.** The first benefit would be the provision of urgent resources at a time of need. It is also an important operation for the Bank's partnership with the Government, to support Iraq at its time of need, while providing a window of opportunity for a longer-term engagement.
- **Strengthening institutional capacity.** The DPL would support the rehabilitation of some of the State's core functions in policy planning and public resource management. It would support the implementation of reforms leading to a stronger institutional capacity in Government and a more efficient allocation of fiscal resources. By raising fiduciary standards, it would reduce the implementation risk of other projects.
- **Supporting the environment for private sector and governance reforms.** Another benefit would be to reinforce and step up the improvements in the currently weak banking system, which is necessary for building up the private sector and it would also support policies that would help improve governance and transparency.
- **Paving the way for a medium and long term engagement on key policy reforms.** Given the situation in Iraq, since reengagement in 2004, the Bank, as well as the rest of the international community, has largely focused on urgent reconstruction needs and institution building. This operation would move toward the more medium- and long-term policy reform dialog the ISN sets out.

- **Signaling to other donors.** The Bank’s support to the Government in the form of the DPL would be a complement to IMF SBA resources, and a possible catalyst for other donors to accelerate their support. The DPL and the IMF SBA would be mutually reinforcing, reflecting complementarity of donor assistance and the operation and each of its pillars would support harmonization of donor assistance by the Government to improve overall aid effectiveness.

G. Risks and Mitigation

203. **This DPL has significant country (security, political and macroeconomic) and fiduciary risks.** General risks affecting the Bank’s program in Iraq would also impact the operation. They include:

204. **Political and economic performance risks.** The ability of the Bank Group to engage with Iraq would become constrained by a reversal of recent, hard-won security gains. Related to that, a deterioration in the political environment either in Iraq or in the Region would also affect the Bank’s ability to implement its assistance program.⁴⁰ The DPL could also be affected by risks related to the Government’s commitment to an ambitious reform program at this time. In particular, the design of a robust program acceptable to the Iraqi authorities might be challenging in an electoral year and during a time where oil prices have started to rise anew. Likewise, a new Government post elections may not agree to implement the same program. Given these political uncertainties, the operation has been designed as a single tranche DPL as part of a programmatic series of two DPLs. This DPL is underpinned by a reform agenda already adopted by the current Government. In addition, this reform program is being implemented with support through ongoing technical assistance programs by the Bank, IMF and other donors. It has also been designed to be realistic, yet consist of important reforms and milestones, complementing existing Government reforms supported by ongoing TA activities, each with their own risk mitigation measures, and opening the door for the Bank to engage with the Government in the medium to long term on critical issues to improve Iraq’s fiscal sustainability. The programmatic approach of this DPL will also help mitigate the risk of relevance and ownership across Governments.

205. **Oil revenue volatility risks.** Iraq has been subject to major fluctuations in its oil revenues, reflecting its extreme dependence on crude oil exports. This makes it extremely challenging to conduct fiscal policy with a medium-term orientation, while maintaining adequate levels of public spending. To help mitigate this risk, this operation aims to support reforms that would help reduce Iraq’s fiscal and socio-economic vulnerability to abrupt changes in oil prices and revenues, as explained elsewhere in this document. In addition, as part of the AAA program under the ISN, the Bank would conduct analytical work and provide technical assistance on oil revenue management issues, including assessing the feasibility of special fiscal institutions such as oil funds in the case of Iraq.

206. **Security risks.** As in many conflict-affected countries, a deterioration of the security situation constitutes a large source of risk for the operation. Continuing security incidents, for example, the attacks in August 2009 and December 2009 against several Government ministries are a manifestation of such risks. The capacity of the Iraqi Government and whether the international community continues to support security will be determinants of the extent of risk that persists. However, the financing from this DPL, and the fact that it is part of an international effort that includes substantial IMF resources, would provide the external financing needed to fill the budget gap. This would help the Government maintain its

⁴⁰ The ISN adopted an *adaptive approach to political and security issue* to deal with these risks. Under this approach, staffing in the Baghdad office, the frequency of missions to Iraq, and the launching and implementation of specific activities would be tailored to the evolving political and security situation on the ground.

recurrent and investment spending to keep the system going while still providing essential services to the population in a fragile and volatile environment, which may help to mitigate some domestic security risks. Support through this DPL is the Bank's contribution to a larger package that will help Iraq continue its physical and institutional reconstruction and thereby reduce destabilizing factors and foster a more secure environment.

207. **Fiduciary Risks.** As indicated in the section on fiduciary assessment, financial controls in Iraq are weak and the operation's fiduciary risk is high. Weaknesses in Iraq's institutional environment increase the exposure of the Bank's resources to fiduciary problems. The fiduciary risks in this operation cannot be mitigated. In the longer term, the Bank is supporting the Iraqi Government in strengthening its public financial management system through PFM Reform Project, which will help strengthen the Government's fiduciary environment for budget support by supporting improved allocation, execution, transparency and accountability in the mobilization and use of all public resources. Furthermore, the Bank has conducted a fiduciary assessment to accompany this operation which has identified weaknesses and areas for improvement.⁴¹

208. **The Bank will also monitor the arrangements made with the IMF for the disbursement of the possible successor SBA.** Since the successor SBA would take the form of budget support, the IMF is seeking the following program safeguards: (i) a Memorandum of Understanding between the CBI and the Government clarifying responsibilities with regard to servicing the debt to the Fund and to the Bank; (ii) verification of the CBI's international reserves as of June 30, 2009 by an external auditor; and (iii) completion of an external audit of the 2008 CBI accounts. More generally, improvement in fiduciary standards is a central objective of this program and continued Bank assistance in the areas of public finance management will help raise these standards and improve budget implementation processes over time.

209. **Program Risks.** The new Government may not borrow the second DPL if the financing needs are reduced or if the post election Government does not want to borrow on IBRD terms, or is not committed to this operation. The new Government may be committed to the general principles of the DPL but may have a different sense of priorities--placing greater emphasis on some components---thus requiring changes in the triggers for the second DPL. To mitigate against the risks that can be controlled, the programmatic approach offers greater flexibility than a tranching operation, and second DPL triggers are proposed to be indicative and based on reforms that are already underway.

210. **Limitations of the civil service in the technical capability to implement the reform program present another source of risk.** Recent reforms and the companion technical assistance projects in each of the three pillars are designed to help build the requisite capacity.

211. In addition, the DPL would be affected by **risks related to the Government's commitment to an ambitious reform program at this time.** The implementation of a robust program acceptable to the Iraqi authorities might be challenging in an electoral year and during a time where oil prices have started to rise anew. Likewise, a new Government post elections may not agree to implement the same program as the previous Government's. To mitigate this risk, this operation has been designed as a single tranche DPL. It has also been designed to be realistic, while opening the door for the Bank to engage with the

⁴¹ They include: a more systematic approach to institution building based on ministry- or agency-specific institutional assessments and action plans; strengthening of the Bank's Baghdad Country Office; continuing use of a Fiduciary Monitoring Agent to supervise project implementation; and support to Iraq's action plan to improve public financial management, both through the PFM Reform project and forthcoming analytical and advisory work.

Government in the medium to long term on critical issues to improve Iraq's fiscal sustainability and efficiency of public spending.

212. **It may also be questioned why the Bank should put in additional resources when the current Bank portfolio is disbursing slowly.**⁴² While the physical investment projects encountered delays, with effort on the part of Government and the Bank as well as improvements in security, the disbursement ratio has increased from 7.8 percent in FY08 to 15 percent in FY09, and the quality of the portfolio is assessed to be improving as reflected in a portfolio with 71 percent of projects assessed at risk in FY07 to 50 percent in FY08 to 20 percent in FY09. This DPL will offer a different type of instrument from the investment instrument which would be a new fast-disbursing approach and pave the way for a more medium to long term engagement in Iraq.

213. **While this operation is risky, the risks of not providing this support would be even greater -** for Iraq to have the financial means to keep the Government systems running and maintain public expenditure for service delivery and reconstruction, at a time of political uncertainty, transition, fragility and financial crisis. It is also an important operation for the Bank to remain a partner in Iraq at its time of need, while providing a window of opportunity for a longer term engagement in Iraq.

214. **Condition of Board Presentation.** To ensure the necessary political commitment on the part of the Iraqi authorities, parliamentary approval of the 2010 Budget is a condition of the Board presentation for this DPL. The 2010 Budget was approved by the Iraqi Parliament (Council of Representatives) on January 26, 2010.

⁴² The ISN contemplates a number of measures to address portfolio risks, including capacity building, strengthening of local oversight capacity, and prudent financial management procedures.

ANNEX 1. LETTER OF DEVELOPMENT POLICY

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No. : 2118

Date : 13/12/2009

العدد :

التاريخ : / /

Mr. Robert Zoellick
President
World Bank
Washington D.C.

Ref.: Letter of Development Policy for the Fiscal Sustainability Development Policy Loan

Dear Mr. Zoellick:

Over the past three decades, Iraq and its people have been adversely affected by dictatorship and conflict. A series of wars, international sanctions and misdirected economic policies under the previous regime have left the country's economy in a state of disarray.

Iraq used to be regarded as one of the most developed countries in the Middle East. However, wars, sanctions and weak governance have contributed to a marked deterioration in Iraq's standards of living in more recent years. Maternal and infant mortality rates have increased, and school enrollment rates have declined over the past decades as a result of low quality of and low returns to education. The unemployment and poverty levels are unacceptably high.

Despite the adverse circumstances, Iraq's Government succeeded in drastically improving macroeconomic performance over the past few years. After reaching 65 percent in 2006, inflation has been kept under single digits. Our currency has been stabilized and dollarization has been considerably reduced. The Government's record demonstrates its commitment to fiscal sustainability and sound macroeconomic policies. As such, direct budgetary fuel subsidies were eliminated by 2007. Even in the face of sharp food price increases in the first half of 2008, inflation was contained at 6.8 percent by end 2008. This has allowed the Central Bank of Iraq to ease monetary policy by reducing the policy interest rate to 7 percent in recent months. With the support of the IMF and the World Bank, progress in strengthening budget management and banking sector reform is underway.

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Furthermore, Iraq successfully concluded a second Stand-By Arrangement (SBA) with the IMF in March 2009. Implementation of the SBA program supported Iraq's macroeconomic stabilization process, leading to much lower levels of inflation and dollarization of the economy. This helped secure the release of the final tranche of much-needed debt relief agreed with the Paris Club. Now Iraq's external debt has reached sustainable levels. I am also pleased to report that considerable progress has been made with non-Paris Club Creditors: The United Arab Emirates agreed on full cancellation of our outstanding debt in July 2008. On March 5, 2009, Iraq signed a bilateral agreement with Tunisia settling an outstanding debt of US\$ 183 million. More recently, China agreed to forgive 80 percent of Iraq's debt of \$8.47 billion, and a draft bilateral agreement was initialed in November 2009.

As with many other developing countries, Iraq was affected by the fallout from the global financial crisis. While our financial sector was mostly insulated from first-round effects of the crisis, we were greatly affected by the abrupt fall in oil prices. Revenues from oil exports account for about two-thirds of Iraq's GDP and for a high percentage of export and fiscal revenues. Oil export revenues are expected to drop by about 38 percent between 2008 and 2009. In particular, Iraq's oil export price is expected to drop from an average of US\$91.5 per barrel in 2008 to a projected average of US\$ 55.6 per barrel in 2009. This means that the real GDP growth is expected to fall to 4.5 percent in 2009 due to the temporary drop in oil production, we seek to increase average crude oil production and exports to 3.1 mbpd and 2.5 mbpd, respectively, by 2012. As a result, we expect real GDP growth to increase to almost 7 percent in 2010 and 7.5 – 8 percent in 2011 and 2012 . We will also strive to keep inflation at around 5-6 percent in the coming years.

As a result, Iraq's fiscal situation deteriorated significantly with the decline in oil prices in the second half of 2008. After holding fiscal surpluses in the order of 8.8 percent of GDP and 1.6 percent of GDP in 2007 and 2008, respectively, Iraq is projected to have an overall fiscal deficit of about 30 percent of GDP in 2009, as oil revenues are projected to show some recovery in the medium term, the deficit would narrow markedly in coming years .

While Iraq has immense reconstruction needs, fiscal adjustment is necessary in face of the revenue shortfall. As a result, Iraq's fiscal expenditures are expected to remain relatively stable in nominal terms over the medium run despite growing public investment requirements. The focus of our fiscal adjustment will be on containing recurrent spending where feasible, while increasing the size and ensuring the effective implementation of our investment budget as dictated by Iraq's reconstruction needs.

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Sound monetary policy played a key role in our macroeconomic stabilization program and the overall credibility of our economic policy. The Central Bank of Iraq (CBI) countered dollarization and reduced inflation through a policy of appreciation of the dinar from November 2006. As inflationary pressures subsided, more recently the CBI shifted gradual appreciation of the Dinar to the maintaining a stable exchange rate vis-à-vis the US dollar. The CBI has also reduced its policy interest rate from 15 percent to 14 percent in January 2009 and to 7 percent in June. These actions responded to reduce price pressures and we expect them to encourage banks to lend money to promote private sector growth.

Our macroeconomic stabilization program has also benefited from the growth in our international reserves in recent years. Reserve accumulation helped Iraq stabilize the Dinar, stop the dollarization process, and reduce inflation. Gross international reserves of the CBI rose from US\$31.5 billion at end-2007 to about US\$50 billion at end- 2008. However, we project, CBI reserves to decline to about US\$43 billion in 2009 given the fall in oil prices during the second half of 2008. We firmly believe in the need to maintain an appropriate level of international reserves to preserve the stability of the Iraqi Dinar, and avoid the resurgence of dollarization and inflation, which hurt the poor the most. As a country with great degree of dependence on the export of a single volatile commodity and on imports of most essential items Iraq faces greater challenges in macroeconomic stabilization which in turn require greater foreign exchange reserves. The CBI is working closely with the Monetary and Capital Markets Department of the IMF in order to strengthen its reserve management capacity.

I. Experience and Achievements to Date

Budget Management and Prioritization

One of the main priorities of the Government is to strengthen both public financial management (PFM) and public expenditure prioritization. The Government firmly believes that a sound PFM system and a clear link between budgeting and policy design are key ingredients in achieving and maintaining fiscal sustainability.

With support from the World Bank, the IMF, and other donors, the Government has designed and is implementing a Public Finance Management Action Plan, PFMAP. The PFMAP is a wide-ranging program underpinned by three main pillars: (i) budget design and preparation; (ii) public procurement; and (iii) cash management, control

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and accounting. The World Bank supports the PFMAR through the Public Financial Management Reform Project.

Despite our political and security difficulties, we have made marked progress in implementing PFM reforms. Specifically, a Medium-Term Fiscal Framework (MTFF) has been in place since 2007. A multi-year budget strategy and a budget with a hard fiscal ceiling were introduced in 2009. Financial reports and audits have been prepared on a more timely basis and with greater accuracy. Delays in closing accounts have been substantially reduced: the maximum delay is now 60 days. We have adopted the GFS Chart of Accounts. The Development Fund for Iraq (DFI), the Central Bank of Iraq (CBI) and State Owned Banks are audited by international audit firms. Audit reports by the Board of Supreme Audit reports are back on track, and multi-year delays are no longer observed. We note that this year we avoided the introduction of supplementary budget, strengthening the credibility of our budget.

The Government of Iraq is committed to strengthening revenue management, particularly with respect to oil revenues. We recognize the need for a system that ensures transparency, accountability and efficiency. Revenue management is a key instrument for mitigating volatility and reducing dependence on crude oil exports. The Development Fund for Iraq fulfills many of these functions and has played a key role in preserving the integrity of our country's oil revenues. Oversight is being transferred from the International Advisory and Monitoring Board (IAMB) as established by the UN Security Council Resolution 1483 (2003) to the Iraqi led Council of Financial Experts. The DFI is the main financing source for Iraq's budget. Audited by an independent international firm and with publically available records, the DFI has provided a level of transparency unparalleled for oil-producing countries in the region. The Government will work with the IMF and the World Bank to develop a successor regime for the DFI which maintains the principle of a single petroleum account and the same degree of transparency and control.

In addition, we are taking concrete steps to fulfil the candidacy requirements for the Extractive Industries Transparency Initiative (EITI). EITI candidacy is a priority for the Government of Iraq at the highest level. It will facilitate our intentions to manage Iraq's resources and revenues transparently for the benefit for all Iraqi people. We have taken several key steps towards this goal: (i) a decree from the Council of Ministers created the Iraq EITI National Secretariat and appointing its Head (Secretary-General); (ii) the Secretariat is in the process of being appropriately staffed; (iii) media articles were published explaining EITI to the public; and (iv) work is underway on a draft EITI work plan, the Multi Stakeholders Working Group

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(MSWG) Charter and preparation for launch event, including publicly advertised invitations to Civil Society Organizations (CSO) to consultation meetings. We are working closely with the World Bank, which is providing technical assistance to our EITI candidacy process.

The Government of Iraq has taken a major step in prioritization of public expenditure. On November 24, 2009, the Council of Ministers unanimously committed itself to implement a Poverty Reduction Strategy (PRS). The PRS articulates a crucial change in budget priorities – eliminating all nonpoor Iraqis from the food ration system and increasing Government spending on services which enable the poor to earn higher incomes from work.

The Poverty Reduction Strategy was developed using a Results-Based-Management approach, starting from a rigorous analysis of the causes and consequences of poverty. The High Committee which developed the PRS included high level representation from a broad range of Iraq institutions including Parliament, the Prime Minister's Office, key ministries, and the Kurdistan Regional Government. The collaborative approach was reinforced by a process of consultation including the private sector, civil society and the international community.

The Poverty Reduction Strategy benefited from support from the World Bank Iraq Trust Fund, including extensive program of institutional capacity building. Through this support, we carried out the first national income and expenditure survey since 1988 and adopted an official poverty line, as well as completing the strategy itself.

With the PRS commitment in place, we are now well positioned to implement a fiscal program that benefits our entire population and which is fiscally sustainable. We expect the PRS to provide a framework for donor support as well as for setting our own budget priorities.

Financial Sector Reforms

The Government of Iraq is fully aware of the centrality of financial sector modernization in fostering private sector-led growth as well as poverty reduction. Enhancing the performance of the banking system, and improving its capacity to provide sound and efficient financial services will make a critical contribution to Iraq's economic growth and prosperity. This in turn would ensure efficient mobilization of funds and allocating them to the most productive investments—promoting private sector development. Of primary importance is to build the capacity

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of the two largest state-owned commercial banks—Rafidain Bank and Rasheed Bank—with their extensive branch network, accounting for more than 70 percent of the banking system, play an effective role in financial intermediation, able to provide the resources needed for Iraq's growth and offer good deposit and payment systems for the business and household sector. This would in a later stage allow private banks to also contribute to the financing of Iraq's development. Underpinning the modernization of the state-owned banks would be the strengthening of the regulatory and supervisory capacity of the Central Bank.

To that end, and with support from the World Bank, IMF, USAID (etc) we are implementing a Banking Sector Reform Program (2008-2012) as well as a number of other financial sector reforms. The goal of the Banking Sector Reform Program is to build a sound and efficient banking system, ultimately capable of providing efficient financial service competitively.

The program draws on the findings and recommendations of the independent comprehensive audits of the Rafidain Bank and the Rasheed Bank that were undertaken by Ernest & Young in 2008.

Under the Banking Sector Reform Program, we are undertaking operational and financial restructuring of both Rafidain Bank and Rasheed Bank. Under Phase I of the Government's restructuring program, the priority is to restructure the commercial banks--the dominant institutions and the only banks with a national network of branches (147 and 142 branches respectively), catering most districts in Iraq (as opposed to only 69 branches on aggregate for the three specialized banks). Moreover, these two commercial banks are the backbone of our payments system and are the only instrument our Government uses to make social security and other nationwide payments. Phase II that will start in late 2012, includes specialized state-owned banks. Key preparatory steps have been taken in that regard. In particular, the Board of Supreme Audits (BSA) has met in July 2009, and agreed on a draft restructuring strategy for the specialized banks (aligned with that for commercial banks), which will be presented to the Banking Restructuring Oversight Committee (ROC) shortly for endorsement.

We are also strengthening the institutional infrastructure for the financial system. This is a key pillar in our financial sector reform program. This included improving internal audit and compliance in the banking system, through: (i) developing further the internal audit (processes, audit framework and methodology, effectiveness of

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internal audit); and (ii) strengthening compliance with laws, regulations and instructions (scope of improvement, compliance framework and methodology, organization). In addition, we are developing the payments, clearing, and settlement systems through the installation of the real time gross settlement (RTGS) system in early 2009. This will reduce total processing time of checks. We have been made progress in raising minimum capital requirements. Moreover, the settlement process of outstanding private claims as part of the liquidation of the London branch of Rafidain Bank is well under way and the process to liquidate fixed assets has begun and expected to conclude by end of 2009.

The Central Bank of Iraq is carrying out a comprehensive assessment of banking supervision authority. It is also working towards strengthening its supervisory and regulatory capacity. CBI has embarked on a comprehensive program of capacity building covering extended areas of the regulatory and supervisory functions. It is seeking to move from compliance to risk-based supervision. CBI is currently working on carrying out an in-depth assessment of banking supervision authority, with the support of the World Bank, IMF, and US Treasury.

We are working closely and collaboratively with the World Bank and other donors in implementing this ambitious reform program. The World Bank, the IMF, the European Union, the US Treasury, and the Financial Services Volunteer Corps (FSVC) have been playing a key role in helping Iraq restructure the banking sector. Through the Banking Sector Reform Project, the World Bank is supporting Iraq authorities in the implementation of Phase I of the "Iraq Banking Reform Strategy" (2008-2012) and its Action Plan.

Social Protection and Pension Reform

The Government of Iraq is committed to a fiscal policy which is both sustainable and protects its citizens from the impacts of oil revenue volatility. As noted previously, the Poverty Reduction Strategy reprioritizes our spending from universal to targeted benefits. Of course, Iraq, like every country in the world, still needs a social protection system for those who are unable to work or who are elderly.

With this in mind, the third part of our program aims to achieve a better targeted and fiscally-sustainable system including safety nets and pensions. We have already made progress in this area, including the formation of a High Committee which is developing an action plan for PDS reform and improving the management and governance of the State Pension Fund.

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To this end, our Government established a High Committee to develop the reform process for the PDS. The High Committee is chaired by the Secretary General of the Council of Ministers and includes Undersecretaries from the Ministries of Finance, Planning, Trade, Labor and Social Affairs, Deputy Governors of Baghdad, Al Anbar and Babil, representatives from the Kurdistan Regional Government and Iraqi Parliamentarians. The High Committee is tasked with development of a concrete action plan for rationalizing the food ration which includes the following key elements: (i) implementing proposed exclusion criteria in the current PDS; (ii) devising an effective targeting tool that supports a robust transition from universal to a targeted program; (iii) reducing the number of products included in the ration; and (iv) improving management of the food ration. The steps we are taking will also afford fiscal space for developing a more comprehensive social protection program in Iraq. Therefore, reform of the PDS will be a critical contribution to the achievement and maintenance of fiscal sustainability in Iraq.

The Government is enhancing the Social Safety Net program which aligns with the Poverty Reduction Strategy. We will gradually shift from simple categorical targeting to more robust targeting mechanisms informed by sound methodologies such as proxy means testing. We recognize that a robust methodology to identify the poor will assist in achieving the overarching objective of effectively targeting the poor and vulnerable Iraqis with a package of safety net provisions.

We are implementing a major pension reform program which will further contribute to our goal of increasing welfare for all Iraqis. We amended the Unified Pension Law in December 2007 to improve financial sustainability and alter the design of public sector pensions in line with good international practices. While the Unified Pensions Law presents a significant improvement, with the Government is building capacity to implement the law, with support from the World Bank and other international organizations.

II. Objectives and Components of the Program

In this context, we consider the support of the World Bank through the *Fiscal Sustainability* Development Policy Loan to be critical. The aim of the loan is to help the Government of Iraq mitigate the impact of the current fiscal crisis on Iraq's economy and to support its medium-term economic reform program, through the following actions:

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Minister Bureau

جمهورية العراق
وزارة المالية
مكتب الوزير

No .:

العدد:

Date : / /

/ / التاريخ:

- Adopting a framework for medium term budget strategy which reflects Government policy priorities and medium term macroeconomic and fiscal projections. The goal is to make the national budget consistent with Government priorities as reflected in Government Program Documents and medium term fiscal framework.
- Adopting the National Poverty Reduction Strategy, which outlines public spending priorities in the social sectors. Ultimately, we aim to improve the alignment of budgetary allocations with the national PRS.
- Enacting a new Public Procurement Law, consistent with the principles of economy, efficiency, transparency and equal opportunities for the public expenditures.
- Implementing the New Chart of Accounts (COA), and issuing a Ministerial Decree establishing a High Level Committee to oversee the implementation of the COA. This will allow for timely, accurate and informative financial reporting allowing for control and accountability as well as analysis.
- Approving a new organization chart for and a detailed program for capacity building in banking regulation and supervision at the Central Bank of Iraq. The medium term goal is to have a banking supervisory system that fully adheres to the Basel Core Principles for Effective Banking Supervision.
- Introducing a real time gross settlement (RTGS) payments system complying with international standards and best practices. We aim to have a fully operational RTGS system in place underpinning our entire banking system, strengthening the payments, clearing, and settlement systems and reducing total processing time of checks.
- Endorsing a strategy for operational and institutional restructuring of Rafidain Bank and Rasheed Bank, paving the way for strengthening Iraq's banking system.
- Settling at least 20 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007, thereby improving the quality of their portfolio.
- Endorsing a policy for the rationalization of the Public Distribution System (PDS), and establishing a High Committee mandated to propose a time-bound action plan for PDS rationalization, as well as adopting a policy for targeting the Social Safety Net program based on the national poverty line. This reform process aims to improve the efficiency and effectiveness of the targeting of social safety nets, allowing for enhanced social impact, strengthened fiscal sustainability of the program, and reduced fiscal pressures on the budget.

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No ..

العدد :

Date : / /

التاريخ :

- Putting in place the management and governance structure of the State Pension Fund (SPF), through (i) approving the executive regulations and by-laws of the SPF; (ii) appointing a General Manager of the SPF; and (iii) appointing the Board of Directors of the SPF. The ultimate objective is to establish a pension scheme that provides old-age income security to plan members in a financially sustainable manner by offering adequate and affordable benefits.

III. Collaboration between the Government of Iraq and the World Bank

The Government of Iraq has successfully implemented this ambitious reform program despite all the challenges it faces. The World Bank has supported Iraq's reform agenda through technical assistance, advisory services, analytical work, and financial assistance.

The implementation of the Government's reform program has also benefited from collaboration with other key development partners, including the IMF, USAID, DFID, the US Treasury and the European Commission.

For the above reasons, the Government of the Republic of Iraq requests the approval of the program.

Yours sincerely,




Baker Jabr Al-Zubaidy
Minister of Finance

/12/2009

Attachment: Fiscal Sustainability Development Policy Loan Matrix

ANNEX 2. POLICY MATRIX

LONG-RUN POLICY OBJECTIVES	DPL I PRIOR ACTIONS (BY FEBRUARY 2010) ⁴³	DPL II INDICATIVE TRIGGERS AND MILESTONES	PROGRAM OUTCOMES (BY MARCH 2011)
I. Strengthening Budget Management and Prioritization			
Budget aligned with government policy priorities	The Ministry of Finance has adopted a framework for medium term budget strategy reflecting Government policy priorities and medium term macroeconomic and fiscal projections	The Ministry of Finance has convened the Budget Strategy Committee for 2011 budget; and has issued the call circular, consistent with medium-term macroeconomic and fiscal projections.	Continued strengthening of the link between policy and budget as revealed by pilot medium term financial planning in two ministries
Improve the alignment of budgetary allocations with the national PRS	The National Poverty Reduction Strategy, which outlines public spending priorities in the social sectors, has been adopted by the Council of Ministers.		The first annual PRS monitoring report completed by the High Committee for Poverty Reduction evaluates alignment between priorities and budget allocations
Public procurement legislative and regulatory framework established to achieve economy, efficiency, transparency and equal opportunities for the public expenditures.	The Shura Council has completed the review of the draft of the procurement law, to be submitted to the Council of Ministers	The Council of Ministers has approved the draft of the Procurement Law and submitted it to the Council of Representatives	Adequate implementation of the new legal framework for public procurement, including: <ul style="list-style-type: none"> ▪ Issuance by Council of Ministers of the Implementing Regulations of the new Public Procurement Law ▪ PPRA established by a Decree of Council of Ministers and full operational ▪ Issuance by MoPDC of the Standard Bidding Documents (SBDs) based on the new Public

⁴³ Prior actions for DPL1 and indicative triggers for DPL2 are in bold font.

LONG-RUN POLICY OBJECTIVES	DPL I PRIOR ACTIONS (BY FEBRUARY 2010) ⁴³	DPL II INDICATIVE TRIGGERS AND MILESTONES	PROGRAM OUTCOMES (BY MARCH 2011)
			Procurement Law and Regulations <ul style="list-style-type: none"> ▪ Ministerial procurement function organized in accordance with the law and the implementing regulations.
Timely, accurate and informative financial reporting allowing for control and accountability as well as analysis.	The Ministry of Finance has issued a decree establishing a High Level Committee to develop the Manual for implementing the Chart of Accounts	Monthly fiscal accounts for the execution of the 2010 budget have been issued no later than 60 days after the end of the month. Board of Supreme Audit (BSA) has completed audit of 2006 Government Accounts. Board of Supreme Audit (BSA) has completed audit of 2007 Government Accounts. The Ministry of Finance has issued the Manual for the implementation of the Chart of Accounts	Timely availability of fiscal accounts for the execution of the 2011 budget; accounts published no later than 60 days after the end of the month. 2011 Budget classification and Chart of Accounts are aligned.
II. Reforming the Financial Sector			
Financial restructuring of the Rasheed Bank and Rafidain Banks improving their portfolio quality	Settlement of at least 20 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007	Settlement of at least 30 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007	Settlement of at least 40 percent of non-performing loans (NPLs) held by Rasheed Bank and Rafidain Bank as of June 2007, as well as improvement in the provisioning levels Rafidain and Rasheed banks diversify their activities beyond deposit taking

LONG-RUN POLICY OBJECTIVES	DPL I PRIOR ACTIONS (BY FEBRUARY 2010) ⁴³	DPL II INDICATIVE TRIGGERS AND MILESTONES	PROGRAM OUTCOMES (BY MARCH 2011)
			and payment transactions, and play a more active role in financial intermediation.
Institutional and operational restructuring of state-owned commercial banks	The Restructuring Oversight Committee (ROC) has endorsed the Banking Sector Reform Strategy and the Action Plan for the operational and institutional restructuring of the two state-owned commercial banks—Rafidain Bank and Rasheed Bank	Completion of Phase 1 of the operational and institutional restructuring of Rafidain Bank and Rasheed Bank	Improvement in the functioning of the two state owned commercial banks, evident in the increase in loan-to-GDP ratios from 4% in June 2006 to 6% in October 2010
The banking supervisory system fully adheres to the Basel Core Principles for Effective Banking Supervision	CBI has approved its new organizational chart and a detailed program for capacity building in banking regulation and supervision	Completion of Phase 1 of the banking regulation and supervision capacity building in program	The banking system is largely adhering to the Basel Core Principles for Effective Banking Supervision
An efficient and effective financial transactions settlement system is in place	CBI has introduced a real time gross settlement (RTGS) payments system complying with international standards	The RTGS system is fully operational	Reduction in processing time of government checks and collections from 25 days to 10 days
III. Improving the Efficiency of the Social Protection System			
<p>The efficiency and effectiveness of the targeting of social safety nets is improved, allowing for enhanced social impact, enhanced fiscal sustainability of the program, and reduced fiscal pressures on the budget</p> <p>A package of social assistance interventions has been prepared,</p>	<p>The Council of Ministers Secretariat has established a High Committee mandated to propose a time-bound action plan for rationalization of the Public Distribution System (PDS)</p> <p>The Council of Ministers has endorsed a policy of reforming the current Social Safety Net through improved targeting methods</p>	<p>The Council of Ministers has approved a time-bound action plan for the rationalization of the Public Distribution System.</p> <p>The Government has prepared an implementation plan detailing exclusion criteria for targeting the PDS</p>	<ul style="list-style-type: none"> ▪ Rationalization of the Public Distribution System (PDS) has been initiated through elimination of high income civil servants from PDS eligibility, as well as other high income groups as determined by the Government ▪ A public information campaign has been launched to announce PDS

LONG-RUN POLICY OBJECTIVES	DPL I PRIOR ACTIONS (BY FEBRUARY 2010) ⁴³	DPL II INDICATIVE TRIGGERS AND MILESTONES	PROGRAM OUTCOMES (BY MARCH 2011)
<p>which is informed by rigorous analysis of available data including the household survey and international experience</p>			<p>targeting objectives and explain the process and timeline for this transition</p> <ul style="list-style-type: none"> ▪ Piloting of Social Safety Net with new and improved targeting mechanism under way
<p>The pension schemes provide old-age income security to plan members in a financially sustainable manner by offering adequate and affordable benefits</p>	<p>The management and governance structure of the State Pension Fund (SPF), has been put in place through (i) approval of the executive regulations and by-laws of the SPF by Council of Ministers; (ii) appointment of the General Manager of the SPF by the Prime Minister; and (iii) appointment of the Board of Directors of the SPF by the Minister of Finance.</p>	<p>The National Board of Pensions has launched the actuarial policy analysis to assess the Unified Pension Law’s fiscal sustainability.</p>	<ul style="list-style-type: none"> ▪ Key provisions of the new Unified Pension Law are implemented; including the discontinuation of labor force segmentation across public and private sectors

ANNEX 3. RELATIONS WITH THE FUND AND ECONOMIC OUTLOOK

February 10, 2010

Contact person: Mr. Ron Van Rooden (rvanrooden@imf.org, 1-202-623-4011)

The Fund has been closely engaged with Iraq since 2003. Initial work focused on providing policy advice, mainly on monetary and fiscal policies, and technical assistance to rebuild essential economic institutions. In September 2004, the Fund approved Emergency Post Conflict Assistance (EPCA) for Iraq, which—in combination with a debt sustainability analysis—paved the way for an agreement with Paris Club creditors in 2004. Since then, Iraq successfully completed two (precautionary) Stand-By Arrangements (SBA), whose main objectives were to achieve macroeconomic stability; promote growth; and continue the process of structural reforms.

Substantial progress has been made since 2003. Despite a difficult security situation, the authorities have demonstrated their commitment and ability to implement sound macroeconomic policies and advance structural reforms. Inflation has been reduced to single digits and the international reserves position has improved markedly. At the same time, domestic fuel prices were raised to eliminate direct fuel subsidies and the pension system was put on a sustainable footing, which created room for priority spending on investment and social sectors. Several steps have also been taken to strengthen public financial management, improve transparency in the oil sector—including with the help of the International Advisory and Monitoring Board (IAMB)—and rebuild capacity at the central bank, while the authorities have initiated the restructuring of the two largest state-owned banks.

Iraq's economic performance was strong in 2008 aided by record oil prices and improved security. Oil production rose to 2.3 million barrels per day (mbpd), the highest level since 2003, compared to 2.0 mbpd in 2007. Crude exports reached 1.8 mbpd, compared to 1.6 mbpd in 2007. As a result, real GDP is estimated to have grown by 9½ percent in 2008, up from 1½ percent in 2007. With the increase in oil export volumes and record-high oil prices, crude oil export receipts reached \$61 billion in 2008—65 percent higher than in 2007—and the current account recorded a surplus of 13¼ percent of GDP. The government budget registered a lower-than-expected surplus of 1½ percent of GDP in 2008. This reflected a significant increase in government spending that more than absorbed the higher-than-budgeted revenues, including a large wage increase granted to compensate for the erosion of real wages that had occurred during previous years.

Following the strong economic performance in 2008, the Iraqi economy has been seriously affected by the drop in oil prices from their peak levels in mid-2008. Also, oil production and export volumes have not increased as much as planned due to lack of investment. As a result, Iraq's external position has deteriorated substantially in 2009, with both the external current account and the overall balance of payments estimated to have shifted into large deficits of about 20 percent and 20 percent of GDP, respectively. With oil export receipts accounting for about 90 percent of government revenues, the lower oil prices

have had a similar impact on the government's budget, which is estimated to have recorded a deficit of over 20 percent of GDP in 2009. The CBI's international reserves declined by almost \$7 billion, to about \$44 billion by end-2009, reflecting the use of government deposits at the CBI to finance the budget deficit. Growth is estimated to have slowed to 4 percent in 2009, even though oil production improved towards the end of the owing to quick efforts to address bottlenecks.

While Iraq's longer-term economic outlook is strong, as oil prices and production are projected to increase, in the near term the current account and overall balance of payments are expected to remain in deficit in 2010 and 2011. Similarly, Iraq's fiscal position is projected to record large, albeit declining deficits in both years, before returning to a surplus position in 2012. The government accumulated financial savings in the DFI and in its accounts with the CBI during previous years, amounting to about \$21 billion at end-2008. However, financing the large budget deficits in 2009–2011, even after mobilizing substantial amounts of domestic financing and utilizing the recent SDR allocation of \$1.7 billion, would exhaust these resources and could result in the accumulation of arrears.

Against this background, the authorities have designed an economic program for the period through end-2011 and have requested the Fund to support their efforts with a new two-year \$3.8 billion Stand-By Arrangement. The authorities view the new program primarily as a way to provide a sound macroeconomic framework during a period of large economic and political uncertainties.

In addition to preserving macroeconomic stability, the new program will also help the authorities move forward with their structural reform agenda. With many of the structural reforms still unfinished, the program aims to advance key reforms in the area of public financial management, including the management of Iraq's oil resources, and financial sector development, in close coordination with a Development Policy Loan (DPL) under preparation by the World Bank.

A key element of the program is to contain current government spending in order to reduce the budget deficit and make room for additional investment. Specifically, current spending in both 2010 and 2011 will be kept broadly unchanged in nominal terms at 2009 levels. This will require some reduction in non-priority spending, as the 2010 budget would need to cover the full-year cost of additional security outlays resulting from the withdrawal of U.S. forces. At the same time, an increase in capital spending is planned for 2010, given the urgent need to improve basic public service delivery. Thus, the budget deficit is expected to be reduced to 19 percent of GDP in 2010, and further to 6 percent of GDP in 2011, before shifting back into a surplus in 2012. Monetary and exchange rate policies will continue to aim at keeping inflation low.

The program will also provide the authorities access to Fund resources, if needed. Iraq's financing needs are strongly influenced by oil price movements. Over the last two years, oil prices have been very volatile by historical standards and projections are subject to a high degree of uncertainty. The program projections assume a conservative price for Iraqi oil of

\$62.5 per barrel in 2010 and \$67.5 per barrel in 2011. As in previous programs, these prices for Iraqi oil are based on the WEO projected prices discounted by an uncertainty margin of 10 percent and by the quality differential relative to the WEO basket. Based on these assumptions, Iraq is expected to have a temporary financing gap of about \$5 billion through end-2011. Oil prices may turn out higher than projected under the program, however. Therefore, the authorities will treat the SBA as precautionary if at the time of each program review oil revenues are projected to reach levels implying that there is no longer a financing need. In the same vein, the authorities would also treat the SBA as precautionary if investment remains significantly below budgeted amounts.

With oil production and prices expected to gradually increase over the coming years, Iraq's economic indicators would steadily improve:

Economic growth is projected to accelerate to 7-8 percent a year in the coming years as oil production gradually increases from 2.4 mbpd in 2009 to 2.6 mbpd in 2010 and 3.1 mbpd in 2012.

Combined with higher oil prices, this will result in a steady narrowing of the current account deficit. Oil exports are projected to rise from 1.9 mbpd in 2009 to 2.1 mbpd in 2010 and further to 2.5 mbpd in 2012, with the current account deficit declining to 2 percent of GDP in 2012, and moving back into a surplus in 2014.

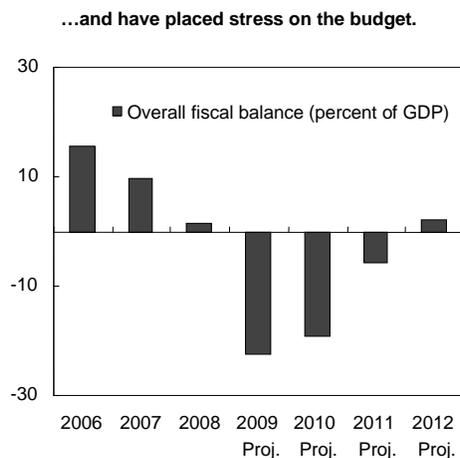
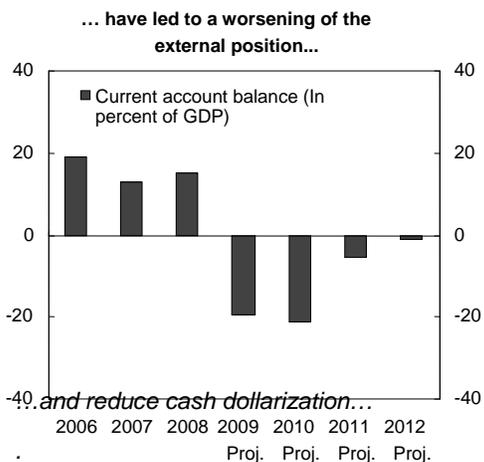
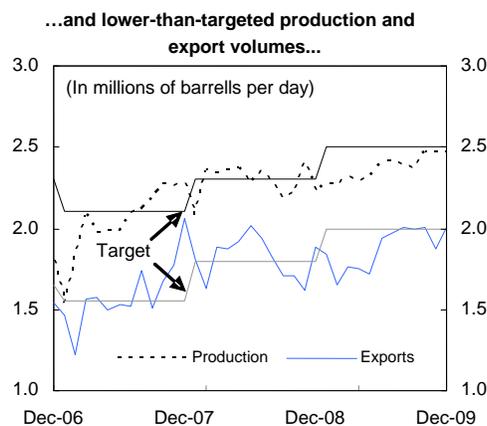
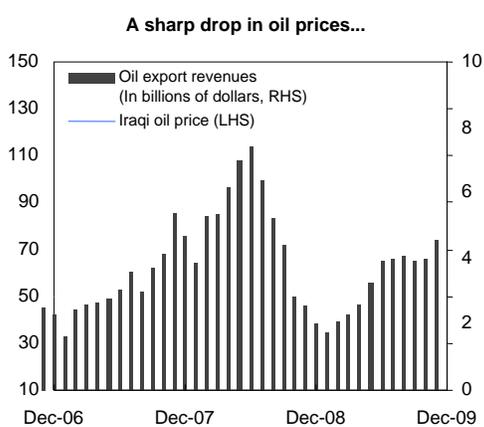
While Iraq's overall reserves would still fall in 2010, they would stabilize in the following years at a level equivalent to about 6½ months of imports, before starting to improve in 2014.

By containing government current spending and allowing for an increase in capital spending, the budget would move back into a surplus in 2012, and remain in a sustainable position over the medium-term.

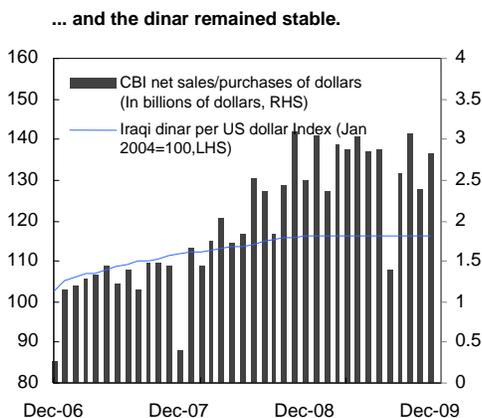
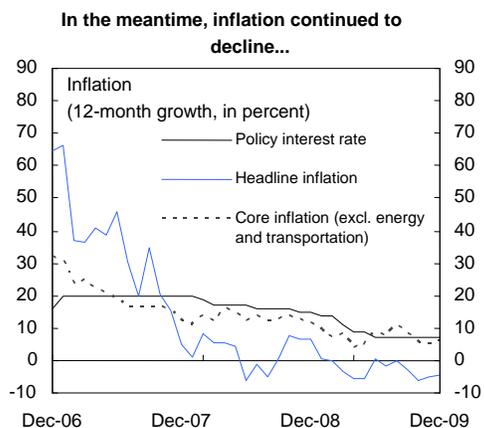
With appropriate monetary and exchange rate policies, headline inflation is projected to remain low at around 5–6 percent a year in the coming years.

Iraq's external debt position would also reach a sustainable position, provided that further progress continues to be made in reaching agreements with non-Paris Club creditors.

Figure 1. Iraq: Macroeconomic Indicators



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Sources: Iraqi authorities and Fund staff estimates.

ANNEX 4. PSIA OF PDS REFORM

The Public Distribution System was introduced in 1991 in response to the declining availability of food imports under UN-imposed sanctions. When the Oil for Food Program began in 1997, government revenue and the ability to import food increased, and the PDS rations increased as well—from about 50 percent of caloric needs to the present level (85 percent of required calories). The PDS effectively reached the vast majority of the population during this period, insulating households against food shortages and price fluctuations. Although malnutrition remained high, the situation would likely have been considerably worse without this safety net.

Today, the food ration system remains Iraq's largest safety net, absorbing 8.6 percent of government spending in 2008 – far larger than education (6 percent) or health (3.4 percent). Although the PDS is successful in providing significant transfers to the vast majority of poor Iraqi's, it is very inefficient as a safety net because it is a universal transfer (provided to the nonpoor as well as the poor) and creates distortions in domestic food markets. The dominant role played by PDS in those markets has massively distorted the incentives faced by Iraqi farmers and private enterprises as large quantities of imported staples depresses domestic food prices, reducing the incentive for domestic production. Low domestic prices also create incentives for smuggling staples outside the country for sale at a higher price.

A variety of proposals for reform of the PDS have been put forth during the last years, but assessment of likely impacts has been difficult due to lack of data. In this PSIA, we perform micro-simulation exercises using the newly available Iraq Household Socio-Economic Survey.⁴⁴

The micro-simulations we present are illustrative of the *medium term* impacts of several reform scenarios: in particular, the simulations assume sufficient supplies of food are available in the market so that there are no major changes in the market prices of food.⁴⁵ We consider the current situation as well as three basic scenarios: elimination of the PDS with no compensating measures; replacement of the PDS with geographically targeted cash transfers; and replacement of the PDS with Proxy-Means-Tested cash transfers.

- The average transfer from the PDS is the equivalent of ID 10,100 per person per month.⁴⁶ Currently, 23.9 percent of the population is below the official poverty line of ID 76,896 per person per month.
- Due to the large size of the existing system, an uncompensated elimination of this system would dramatically reduce the consumption of the poor as well as the nonpoor – in effect subtracting the value of the PDS ration from the ID 61,624 welfare level of the average poor person and from the ID 126,944 of the average Iraqi. In this scenario, the poor would get poorer and an additional 10.5 percent of the population would fall into poverty.

⁴⁴ The Iraq Household Socio Economic Survey (IHSES) is the first nationally representative income and expenditure survey in Iraq since 1988. IHSES was fielded from October 2006 through November 2007 with assistance of the World Bank.

⁴⁵ A short term transition plan will be essential for any reform scenario. Because the PDS is such a large system and is dominated by the role of the public sector for importing, storing and distributing food, a plan must be in place that helps the private sector develop the capacity to take on these roles. Without such a plan, food prices are likely to rise dramatically, with large poverty and redistributive impacts.

⁴⁶ The size of the transfer is calculated based on the quantities of ration products actually received by households, as observed in the IHSES, evaluated at local market prices.

- Introducing targeting, by providing transfers to a smaller number of people, allows the size of the transfers to increase. Our geographic targeting⁴⁷ scenario assumes the same resources as the PDS, but allocates a cash transfer only to those who live in a limited number of geographic areas, selected on the basis of their high poverty rates.⁴⁸ Use of geographical targeting results in a poverty headcount of 18.6 percent – an improvement over the existing PDS system of 5.3 percentage points.
- The second targeting mechanism we consider is Proxy Means Testing (PMT), which is based on the assessment of a small set of household characteristics, chosen on the basis of their correlation with poverty, ease of verification, and difficulty in being manipulated by potential beneficiaries. In PMT, the information on household characteristics are combined with fixed weights to obtain a score which is then used to determine eligibility.⁴⁹ The result of this simulation is a poverty headcount of 15.0 percent of the population – an improvement of 8.9 percentage points.

	Poverty headcount	Poverty gap	Mean per capita monthly expenditure	Mean per capita monthly expenditure among the poor	Transfer to the beneficiaries (monthly, per capita)
Existing situation	23.9%	4.5%	ID 126,944	ID 61,624	ID 10,100
Elimination of PDS with no compensating measures	34.4%	9.1%	ID 115,151	ID 56,538	
Replacement of the PDS with geographically targeted cash transfers	18.6%	3.6%	ID 127,940	ID 62,152	ID 32,851
Replacement of the PDS with Proxy-Means-Tested cash transfers	15.0%	2.5%	ID 127,822	ID 64,058	ID 33,545

In conclusion, these simulations illustrate that commonly used targeting mechanisms have the potential to improve the poverty reduction impact of the current PDS budget – from 23.9 percent of the population to as little as 15.0 percent.⁵⁰

⁴⁷ Targeting based on the location of the residence is very common due to its simplicity (see, for example, Coady, Grosh and Hoddinott, 2004).

⁴⁸ We rank the 54 geographic areas used for sampling in the IHSES (18 governorates separately by rural, governorate centers and other urban centers) on the basis of their poverty headcount. If we aim to reduce the headcount at a national level, the optimal number of targeted areas is twenty-two. (This optimization reflects the tradeoff between the number of poor people covered by the program and the size of the transfer to each beneficiary.) The accuracy of geographic targeting can be improved by use of more disaggregated geographic areas. Too fine a disaggregation, however, creates administrative problems by creating incentives for households to cross geographic boundaries in order to obtain benefits.

⁴⁹ In our micro-simulations for Iraq, the preferred specification includes: socio-demographic characteristics of the household (household size, household head gender and age, a dependency ratio, educational attainment of the household head), housing characteristics (whether the house is rented, crowding, materials of the ceiling and floor, quality of the sewage system and of the road leading to the house), geographical location, labor market status of the household head and whether he/she works in the public sector. If we aim to reduce the headcount at a national level, the threshold for eligibility is set at the 36th percentile of the estimated welfare distribution.

⁵⁰ Alternatively, targeting could permit a smaller budget to maintain a constant rate of poverty.

ANNEX 5. POVERTY REDUCTION STRATEGY OUTCOMES, OUTPUTS AND ACTIVITIES

1. Higher income for the poor from work.

1.1 Factors for increasing productivity of agricultural work are made available to the poor.

- 1.1.1 Provision and maintenance of infrastructure supportive to production and marketing.
- 1.1.2 Programs to train farmers on modern agriculture and irrigation techniques.
- 1.1.3 Review the package of agricultural legislation and policies in favor of poor farmers:

1.2 Lending programs for income-generating projects for the poor are implemented.

- 1.2.1 Introduce regulations to ensure larger coverage of the poor by lending programs to help them establish small income-generating projects.
- 1.2.2 Conduct awareness campaigns for the poor to make use of the programs.
- 1.2.3 Organize training programs to help the poor make good use of loans.

1.3 A system for revising the minimum wage based on changes in the poverty line is adopted.

- 1.3.1 Conduct inspection visits to monitor proper application of the law.
- 1.3.2 Articles are included in the Labor Code specifying a minimum wage that is proportional to the poverty line.
- 1.3.3 Acquaint the workers, who receive minimum wage, with their rights for wages consistent with the poverty line.
- 1.3.4 Designate a unit in the employment offices in all governorates, where workers can report to when employers do not comply with the law.

1.4 Effective employment offices established in the rural areas and are accessible by the poor.

- 1.4.1 Employment offices coordinate with the private sector to provide job opportunities.
- 1.4.2 Employment offices coordinate with the agencies responsible for training, rehabilitating and enhancing the poor's working skills.
- 1.4.3 Support the activities of the employment High Committee.

1.5 Government supports pro-poor initiatives by civil society.

- 1.5.1 Participation in income-generating programs for the poor, which donors contribute to.
- 1.5.2 Government provides facilities and funding to organizations which have programs targeting the poor.

1.6 Evening handcraft centers and rapid training programs have been established or activated for the poor on income generating vocations.

- 1.6.1 Organize awareness campaigns encouraging the poor to enroll in training centers and programs.
- 1.6.2 Civil society organizations participate in operating training centers for the poor.

2. Improved health status of the poor.

2.1 Primary health care centers are improved and accessible by the poor.

- 2.1.1 Training of personnel of primary healthcare centers.
- 2.1.2 Construction and equipment of primary healthcare centers.
- 2.1.3 Increasing the number of mobile clinics for remote areas.

2.2 Awareness of behavioral risks for communicable and non-communicable diseases is increased.

2.2.1 Conducting awareness campaigns through TV, broadcast, printed media and seminars.

2.3 Government program to supply potable water and sanitation services to poor areas is implemented or underway.

2.3.1 Expanding potable water projects to reach the poor areas.

2.3.2 Expanding sanitary excreta disposal project.

2.4 Poor areas coverage by the activities of the Expanded Program of Immunization is enhanced.

2.4.1 Strengthening epidemics monitoring system for communicable diseases.

2.4.2 Implementing vaccination campaigns.

2.4.3 Maintenance of campaign requirements (vaccines, disposable materials, cold chain, and transport).

2.5 Nutritional status of the poor is improved.

2.5.1 The poor continue to receive full ration items.

2.5.2 School meals are to be re-introduced to primary schools.

2.6 Program to enhance reproductive health for the poor is prepared and implemented.

2.6.1 Implement awareness programs on reproductive health.

2.6.2 Training of medical and health personnel.

2.6.3 Continue to provide materials and standard requirements (with international standards).

3. Expansion and improvement of education for the poor

3.1 Compulsory basic education law and regulations are issued and activated, particularly in poor and rural areas.

3.1.1 Amending Article (34/First) of the Constitution to extend compulsory education to the intermediate stage (third year intermediate school).

3.1.2 Build a database for the age group covered by compulsory education according to geographic distribution, focusing on poor rural areas for easy follow-up with the households who have children in this age group.

3.1.3 A partnership program between government and civil society organizations and ministries related to the implementation of compulsory education.

3.1.4 Activate the relationship with fathers-teachers councils in a legal and institutional form designed to disseminate compulsory education culture.

3.1.5 Review the terms of reference of the Education Information Department in order to raise awareness on the importance of commitment to compulsory education.

3.1.6 Monitor and follow-up on the drop-outs in the compulsory education age group as part of the Ministry of Education annual plan (teachers field teams, considering reduced drop-out rates as criterion for efficiency, etc.).

3.1.7 Lobbying in support of the amendment of the constitutional article related to the extension of compulsory education in the constitution.

3.2 Priority is given to construction of primary, intermediate and secondary schools in poor areas.

- 3.2.1 Establishment of a database on the distribution of educationally poor areas (geographic and administrative) according to deprivation rate from intermediate and secondary schools.
- 3.2.2 Allocate enough funds in the education investment budget as per schools' levels (priority to government investment expenditure in education) with priority given to the construction and rehabilitation of intermediate and secondary schools in villages and poor neighborhoods according to appropriate time-bound plans.
- 3.2.3 Achieve compatibility between the requested school area and the number of students covered by compulsory education in the geographical area (school seating capacity).
- 3.2.4 Set a program to provide support to the local governments in building and rehabilitating schools, especially intermediate and secondary schools.

3.3 The law and instructions of the Social Protection Net have been amended to allow linkages with the registration of the children of families covered by the net in basic education.

- 3.3.1 Build a database at governorate, Qadha and Nahiya levels on children at basic education age from households which benefit from the Social Protection Net.
- 3.3.2 Revise the Social Protection Net law and instructions to ensure enrollment and attendance of children from beneficiary households.
- 3.3.3 Prepare a mechanism for exchange of information between MOE and MOLSA.

3.4 Educational efficiency has improved in poor urban and rural areas.

- 3.4.1 Priority in distributing efficiency related education services (e.g. laboratories, teaching aids, etc.) is given to poor quarters, areas and neighborhoods.
- 3.4.2 Giving priority to training of teachers and instructors in poor urban and rural areas.

3.4.3 Measures and activities have been undertaken to reduce the number of illiterates.

- 3.4.4 Issuance of Illiteracy Eradication Law.
- 3.4.5 Establish illiteracy eradication centers.
- 3.4.6 Organize awareness campaigns to encourage enrollment in illiteracy eradication centers.

3.6 Programs which link vocational education with the labor market needs, especially in the agricultural and rural sectors, are prepared and implemented.

- 3.6.1 Provide and promote the wide use of international reports and publications regarding the link between vocational education and labor market needs.
- 3.6.2 Establish programs to upgrade the efficiency and quality of vocational education and serious follow up of implementation.

4. A better living environment for the poor.

4.1 State projects to build appropriate housing units for the poor on easy terms have been expanded.

- 4.1.1 Implementation of projects for building low cost housing complexes for the poor.
- 4.1.2 Development and implementation of rules and procedures for selecting beneficiaries.
- 4.1.3 Development and implementation of rules and procedures for recovering the costs of housing units from beneficiaries on concessional terms.
- 4.1.4 Development and implementation of programs and mechanisms to involve the poor in the identification of the type of housing best suited to their needs.
- 4.1.5 Encourage Awqaf funds administrations and social security and minors funds to participate in funding low-cost housing projects.

4.2 A program to encourage participation of the private sector in low-cost housing has been designed.

4.2.1 Taking measures to encourage participation of the private sector in building housing units in poor neighborhoods.

4.2.2 Taking measures to provide infrastructure for these projects.

4.3 Dwellings are surrounded by suitable environment.

4.3.1 Implementation of projects for paving and lighting roads in poor areas.

4.3.2 Provision of public transport services.

4.3.3 Organization of market places in poor areas.

4.3.4 Provision of garbage disposal services.

4.3.5 Establish sports and scientific clubs and public parks.

4.3.6 Awareness programs for the poor on preservation of the environment surrounding their dwellings.

4.3.7 Provision of maintenance services for installations surrounding the dwellings.

5. Effective social protection for the poor.

5.1 Procedures have been adopted to guarantee proper application of the Social Protection Net.

5.1.1 Take measures to adopt decentralization in administering the Social Protection Net.

5.1.2 Develop a database of beneficiary households and update it on a continuous basis.

5.1.3 Design a capacity building program to qualify and train personnel on proper application of the Social Protection Net.

5.1.4 Prepare firm monitoring report on work mechanism and law implementation by the Ministry of Labor and Social Affairs.

5.1.5 Expedite the Smart Card System procedures.

5.1.6 Design a media program addressing the public to make them aware of their rights, eligibility conditions and penalties for breach of the Social Protection Net regulations.

5.1.7 Initiate partnership with civil society organizations for targeting the poor and evaluating the Social Protection Net.

5.1.8 Establish a mechanism to link the amount of assistance with the inflation rate, with a possibility for issuance of inflation rates for essential commodities.

5.1.9 Set a mechanism to cover the displaced people by the Social Protection Net.

5.1.10 Set a mechanism to cover the beggars by the Social Protection Net.

5.2 The national poverty line is used for specifying the categories targeted by the Social Protection Net.

5.2.1 Updating the national poverty line on annual basis using data from household surveys and other statistical sources to determine which households are targeted by assistance.

5.3 Procedures to phase out the Public Distribution System, by targeting the poor, are established and implemented.

5.3.1 Transfer the savings from Public Distribution System targeting to the budget of the Social Protection Net.

5.3.2 Establish a system for monitoring and evaluating the reform of the Public Distribution System.

6. Less inequality between poor women and men.

6.1 Programs for addressing the causes of low enrollment rates for girls (in elementary, intermediate and secondary school) are expanded.

- 6.1.1 Hold at least one awareness seminar in poor areas before the beginning of the academic year to spread the culture of enrollment in education and urge for compulsory education and universal education for girls.
- 6.1.2 Give priority to the establishment of girls' primary and secondary schools in poor areas
- 6.1.3 Activate the system for the monitoring and evaluation of enrollment rates in primary and secondary schools and identify progress achieved.
- 6.1.4 Provision of logistical facilities (e.g. transport and others) to help girls reach their schools.

6.2 Specialized training programs aimed at increasing job opportunities for poor women are implemented.

- 6.2.1 Implementation of awareness programs (at least one) before the start of academic year in the poor areas in order to disseminate the culture of school enrolment and to urge for compulsory primary education and girls universal education.
- 6.2.2 Establish cooperation framework with the private sector to urge it to support vocational qualification programs in rural areas.
- 6.2.3 Adoption of a continuous follow up system to assess the training and rehabilitation programs for women.

6.3 Legislations and programs have been issued to ensure social security for poor women.

- 6.3.1 Establish a social security fund for workers in informal sector.
- 6.3.2 Establish an effective monitoring system for the implementation of the Social Security law to ensure the rights of working woman.
- 6.3.3 Organize awareness programs targeting women, especially in rural areas, to abide by the social security system.
- 6.3.4 Prepare pro-women programs to guarantee and acquaint women with their rights.

ANNEX 6. FRAMEWORK FOR INSTITUTIONAL AND OPERATIONAL RESTRUCTURING OF STATE-OWNED BANKS

I. General Scope of the Program

1. This note defines the overall framework of the program of operational and institutional strengthening which will enable the Bank to function successfully as a modern, competitive commercial bank. Due account is being taken of the effectiveness and reliability of the Bank's accounting, financial, administrative and control procedures and their upgrading. The Iraq authority has commissioned a comprehensive independent audit—to assess the Bank's performance, outline the main areas of institutional weaknesses and present recommendations to address the weaknesses detected. The next step would be a set of detailed measures aim at implementing an operational and institutional action plan under the scrutiny of the Restructuring Committee headed by the Vice Governor of CBI. The US Treasury is assisting the two state-owned banks in drafting this detailed action plan. But more technical help (consultants) should be needed to assist the two state owned banks in the institutional and operational restructuring focusing on management functions, human resources, and IT and MIS, as well as, strengthening accounting, reporting and auditing policies and procedures in compliance with international best practices.

2. More specifically, the objective of the program is to support the CBI, the state-owned bank's board of directors and management team efforts in developing a detailed, credible business strategy and plan, and to recommend, inter-alia, steps that should be taken to streamline operations, optimize the branch and distribution network, and strengthen organizational, operational and management structures. The plan proposed under the program should include a candid and detailed assessment of needed professional skills in critical business areas (front, middle and back office), as well as staffing and staff training. The strategy of the public banks would need to be strictly defined under its proposed business plan to preclude lax lending policies and ensure a level playing field for all banks with private as well as public ownership. The proposed scope of work under the program should cover – as detailed in the following sections – the specific areas of: (i) strategic and business planning; (ii) organization structure; (iii) budgeting and performance measurement; (iv) management information system and management accounts; (v) operations; (vi) automation and technology support; (vii) internal audit; (viii) credit analysis and portfolio management; (ix) asset and liability management; (x) market development and marketing; and (xi) human resource management and training.

A. Strategic and Business Planning

3. The public banks should consider creating a strategic and business plan. Given the need to build and develop the Bank in a changing economic and market environment, the completion of a comprehensive strategic plan is a priority as it is the necessary foundation for building a program of institutional change. The banks' mandate from the owner would provide the basis for formulating the strategy. The strategic plan must clearly define the Bank's mission and objectives, target markets, products and services, financial goals, resource requirements and action plans for executing its strategy and achieving its goals and objectives.⁵¹

4. One of the program's outcomes will be to support the board of directors and management design and implement a formalized strategic planning process for the Bank as a whole and the individual business and staff units. That process must establish how the task of planning is organized, conducted and monitored on an on-going basis. The role of various departments (including, if necessary a specialist strategic planning unit within the banks) in the planning exercise must be established and the steps in the process with appropriate deadlines for completion of tasks must be outlined and agreed with the banks' management.

⁵¹ Page 22 of the Rafidain Bank and Rasheed Bank reports.

5. The preparation of the strategic plan will be based inter-alia on the analysis of the external environment, the competition, current and potential markets, and the banks' current market position. To this end, there would be a need to conduct relevant internal analyses to identify the banks' strengths and weaknesses in relation to the market, the competition and future business opportunities. These internal analyses should include profitability analyses of existing businesses such as corporate and consumer lending. It is expected under the program, that the banks' board of directors and senior management would then address and define the banks' mission and strategy, and prepare business and action plans to execute that strategy. This corporate strategy will then be extended into a series of plans, each covering a major business of the banks – defining specific goals, target markets, products and services, resource requirements, and actions programs as needed to provide practical guidance to each business unit and tools for monitoring and evaluating performance.

6. In the frame of the program, it would be expected to train banks' staff in strategic and business planning in the course of the work, so that the banks have the ability to continue the planning process in the future. Any identified gaps in critical skills within the banks should be reported to management.

B. Organization Structure

7. Once the strategy and business plans are developed, the banks must review their organizational setting so that it may execute its strategy successfully.⁵² In this regard, the banks' Board and management will work together to develop and document the organization structure of the head-office and their specific relationships to the branch offices. This would entail a definition of each organizational unit (including permanent committees), its mission, main responsibilities, key functions to carry out each responsibility, and required staffing levels.

8. To build the new organization structure, the Bank's board and management will define the specific requirements and will be expected to prepare a plan for implementing the new organization indicating implementation actions and responsibilities, schedule and support requirements.

C. Budgeting and Performance Measurement

9. The budgeting functions in the public banks are at a very early stage.⁵³ The banks do not have a Budgeting Committee, which is a key internal body to oversee this core function. In the current situation, the budgeting functions are part of the finance department and report to the management. It would be best practices to establish such an independent committee within the banks. The budgeting process within the banks suffers from major weaknesses (no information system to prepare, compile and monitor the function's processes, There will be a need to strengthen the banks' existing capital planning and budgeting systems. The objective will be to ensure that the capital planning (in terms of economic rather than regulatory) and budgeting systems are sufficiently comprehensive to meet fully the needs of the banks, including as a basis for providing incentives for, and controlling, management and staff performance throughout the institution. The banks will have to revise their system which should be formally linked to the strategic planning process to ensure that the annual financial plan for the banks truly represents and reflects the strategic objectives.

10. Beyond the necessity to close those gaps⁵⁴, the budgeting process will have to ensure that individual branches and units within the banks prepare budgets for all income and expenditure items over which they have responsibility. The process should ensure in particular that: (i) annual budgets for the banks and its

⁵² Page 24 of the Rafidain Bank and Rasheed Bank reports.

⁵³ Page 31 of the Rafidain Bank and Rasheed Bank reports.

⁵⁴ Page 32 to 37 of the reports.

departments and branches are linked to the strategic planning process and objectives; (ii) budget targets are agreed to between head-office and individual department and branch managers to ensure challenging but realistic targets and secure good motivation and performance from managers; (iii) detailed and relevant variance analyses take place on a regular basis and all significant variances from the banks' targets and objectives are highlighted and explained as necessary and corrective actions are initiated; and (iv) the management accounts for the banks and its constituent parts are designed to report actual performance against budgets and strategic targets..

11. In addition to variance analysis, the banks will have to ensure that they have a comprehensive system of measuring performance against targets through the use of a well defined set of management accounts and reports and through a system of individual performance management (they will also have to state the milestones at which they will measure their performances). The banks will train a core staff in the utilization of the new systems and processes that may be developed.

D. Management Information System and Management Accounts

12. There is a need to define the information required to manage the banks, measure their performances and control their risks. On completion of the banks' strategic plan, a detailed plan of the management information required to execute the strategy will need to be completed, including management reports at each managerial level. The new management information requirements must be integrated into the automation strategy of the banks.

13. In assessing the adequacy of the existing management information system and recommending adjustments as needed, the Bank will ensure that the management information plan would cover all the key areas of Bank operations and management, including: (i) credit and portfolio status; (ii) treasury including liquidity, interest rate and FX risks, funding, asset and liability management, and deposits management; (iii) operations (front, middle and back-office), head-office and branches; and (iv) strategy, budgeting and performance measurement including the design and implementation of an appropriate management accounting system. A key item will be improving the interconnection of bank branches with the banks' headquarters.

14. This will cover the accounting system needed to provide management with reliable and timeliness financial information for each of the operational units and product lines, as well as for the banks as a whole. The accounting system should include information on a profit and cost-center basis with appropriate transfer pricing for inter-unit transactions. The management accounts should also be designed to give revenue, cost and profitability information by product, customer, branch and business line.

15. The banks' management will ensure that the new management information requirements, including the management accounts, are integrated into the automation strategy and technology support framework of the banks. Rafidain Bank and Rasheed bank will also need to train a core staff in the utilization of the new systems and processes that may be developed.

E. Operations

16. In light of the strategic plan – which would have addressed the systems requirements for new business units—the adequacy of the banks' operating systems and procedures will be assessed, together with the need for their strengthening to ensure their effectiveness. There will be a need to ensure that any strengthened or revamped systems would take into account the banks' planned businesses, methods of operations, service and control requirements and the automation strategy.

17. New operations systems and procedures would need to cover both head-office and branch operations and other product/service production and distribution networks/systems, and the interconnection of the branches with headquarters. Indeed, with intensified competition for products and services, and pressure on margins, it would be necessary to strengthen operations at the branch level. These efforts will involve substantial training of the banks' branch staff in handling basic deposit-taking transactions, using computers. They will also involve development of loan officers' capacity. Unless training can be held in Iraq, these efforts will involve training of a cadre of selected bank staff outside Iraq to act as trainers of the staff ("training of the trainers") in Iraq. The numbers trained at this stage are projected to be at least one from each branch of the two banks. Following the training of these cadres, training programs will be set up in Iraq, if possible linked by video conference to the original trainers of the trainers so they can provide answers to more complicated questions. This is likely to entail travel to a centralized training center in Iraq. Finally, the project will support better use of information technology and inter-connection of branches of the banks. At the moment, efforts have been made to improve functions of Rafidain Bank's head office and foreign offices but efforts are needed to train staff in the rest of Rafidain and in Rasheed.

F. Automation and Technology Support

18. The current information systems within the public banks run on an antiquated environment.⁵⁵ There is no information security function in the banks or formal information security policies and procedures in accordance with international standards. In the same vein, the banks have not developed any disaster recovery site or disaster recovery plans.

19. Moreover, there is no IT governance or IT strategic planning in the public banks and information security as well as IT operations is currently managed on an ad-hoc basis. To ensure that IT systems (i) support efficiently the key current banking operations, (ii) meet the current and future business needs and user's expectations and (iii) effectively manage, maintain and control data availability, integrity and confidentiality, banks' management should consider defining an IT strategy development framework at short notice and have a formal information system strategic planning document in place. This IT strategic plan will have to support fulfillment of the overall operational banks' strategies and enable business growth.

20. Once the management information needs have been defined, the efficiency and effectiveness of the hardware architecture and system engineering in the Bank will be reviewed and evaluated (taking into account any contingency plans relating to business continuity risks). In so doing, due account will be taken of the need for congruence between the banks' strategy, business goals, and existing technology. The work would require more specifically: (i) an assessment of the information and processing requirements, and a definition of a set of additional application needs for the banks; (ii) an analysis of the information and processing effectiveness of existing systems; (iii) an estimate of the cost of additional hardware, software (especially for the basic banking functions related to customer accounting, portfolio analysis and management, FX operations, etc...); (iv) an outline of the management, organization, manpower and training requirements needed to implement the program; and (v) an implementation schedule together with critical milestones. Due attention will be needed in integrating any new initiative: internally, with regard to a compatible system of hardware, software and communications from branch to head-office; and externally, with any new payments system and inter-Bank arrangements.

G. Internal Audit

21. The Ernst & Young audit concluded that the internal control system of both banks does not meet the international standards. Several major flaws are flagged. Chief among these, (i) the banks do not have an

⁵⁵ Page 43 to 85 of the Operational diagnostic review reports.

active audit committee;⁵⁶ (ii) the internal audit functions are not independent and (iii) the internal audit functions' methodology is based on compliance testing rather than a risk-based approach. Banks' internal audit schemes will have therefore to be strengthened.

22. In line with the strategic plans and the implications of these plans – in terms of organization structure, financial instruments, operations, systems and procedures, and automation – there will be a need to propose adjustments as required to the internal audit system and process with appropriate corresponding manuals.

23. There will be specifically a need to: (i) advise on improvements to audit methodologies, and adequacy of audit coverage in terms of scope (e.g. credit, operations, assets and liabilities management), depth and reporting standards; (ii) suggest required follow-up and monitoring; (iii) define the audit organization; and (iv) identify complementary audit skill requirements. The Bank auditing staff will need to be trained in the utilization of new methodologies (risk-based versus compliance-based). This sub-component – which requires specialized skills - would call for interaction with/involvement of the external auditors.

H. Credit Analysis and Portfolio Management

24. Long standing problems of portfolio quality have taken a heavy toll on the banks' operations and financial position. The Ernst & Young asset quality reports show that loan loss reserves are largely underestimated (239 billion IQD for Rafidain Bank and 138 billion IQD for Rasheed Bank).⁵⁷ In terms of capital adequacy, regulatory capital shortfalls –based on Basel II requirements and worldwide practices in terms of classification and provisioning of bad assets- may vary between 359 billion IQD for Rasheed Bank and 15.3 trillion IQD for Rafidain Bank).⁵⁸ With regard to the credit administration process, several weaknesses were identified within the banks: (i) the Credit Committees do not have a charter spelling out *inter alia* their mission, objectives, authorization matrix;⁵⁹ (ii) the banks credit functions do not forecast the cash flows generated from loan collections and do not perform a reassessment of the collateral value; the banks do not collect customers' financial statements.⁶⁰

25. A formalized and thorough management and operational structure delineating credit policies, procedures and systems must be developed as a matter of priority. Special emphasis should be given to portfolio control and problem loan management. The revised structure should bring up-to-date market skills and techniques to the process of credit management, especially in the context of the asset quality problems faced by the banks. The banks' management will need to enhance credit management policies, procedures and systems, regarding both aspects of credit analysis and portfolio management, and problem loan management.

26. (a) Credit analysis and portfolio management. There would be a need for improvement in policies and procedures regarding: (i) target market guidelines; (ii) portfolio limits; (iii) risk tolerance criteria; (iv)

⁵⁶ Operational diagnostic review reports (page 91).

⁵⁷ Amounting to US\$ 204 million and US\$ 117 million (IQD 1,000 = US\$ 0.8521)

⁵⁸ Amounting to IQD 306 million and US\$ 13.1 billion (18.4 % of GDP—the 2008 GDP would reach IQD 83.6 trillions, ie. US\$ 71.2 billion). The capital shortfall of US\$ 13.1 billion (Rafidain Bank) is based on a number of adjustments which are likely to be required. Chief among these is a difference arising from the reevaluation of assets and liabilities denominated in foreign currencies. IQD 8.33 trillion (US\$ 7.1 billion) are currently recognized as an asset due from the Ministry of Finance and are included within "other assets" of the Rafidain Bank. This amount relates to 2006 and may be recognized as an expense in the income statement.

⁵⁹ Page 101 of the operational diagnostic review reports.

⁶⁰ Page 12 of the asset quality reports.

credit approval authorities; (v) credit analysis, structuring and pricing; (vi) loan documentation, contracts and security; (vii) loan disbursement procedures; (viii) loan follow-up and monitoring; (ix) credit recovery and legal enforcement; (x) credit administration and controls, including disbursement, amendment to terms and other sanction authorities, credit audit and policy exceptions; (xi) organization of credit within the context of the strategic plan; and (xii) automation of reports needed to monitor asset quality.

27. (b) Problem loan management. There would be a need to optimize policies, procedures and organizational arrangements [including if warranted, special workout unit for certain types of problem assets] related to: (i) problem loan definition and identification; (ii) problem loan reporting; (iii) problem loan follow-up; (iv) delinquent loan recovery; (v) viability analysis and loan restructuring options; (vi) repossession and legal recovery actions; and (vii) provisions and interest accruals.

28. There will be a need to train a core staff in the utilization of each of the new processes that may be developed.

I. Asset and Liability Management

29. For both public banks, the Ernst & Young asset quality reports show that the banks do not have a formal ALM function.⁶¹ There are no centralized treasury departments to perform treasury function related processes and there is no documented policy and procedures manual to govern ALM processes.

30. The banks management will have to design and activate an ALM function as part of the revised organizational structure of each bank. The skills, policies and systems required to manage these risks must be strengthened, so that comprehensive risk management policies be developed or improved to govern interest rate, liquidity, FX and other non-credit related risks. In this regard, the management will be responsible for the implementation of the processes, the organization, and the information systems required managing the range of ALM risks currently facing the banks and any additional risks inherent in the execution of the banks' strategic plan. The management will have the responsibility of developing and documenting processes to cover, at a minimum, such ALM areas as liquidity, interest rate and duration gap and pricing, and FX. Further, the management will put in place an organization structure that will execute the proposed, upgraded ALM processes - defining specific responsibilities, authorities, and functions of each unit, as well as required staffing skills. In addition, it will be necessary to define the information required to support the ALM processes (e.g., external and internal information, formats and time-frames).

31. There will probably be important needs to train key staff (treasury staff and management, and other senior managers who will participate in, or contribute to, ALM decisions) in utilizing the ALM system and implement the practical day-to-day functions.

J. Market Development and Marketing

32. There will be a need to assess the adequacy of the banks' formal marketing function and strategy and the degree to which these are aligned to its activities and to the requirements of the market. This would include an assessment of staff marketing and sales experience. In this regard recommendations, as needed, regarding adjustments to the marketing function and strategy would need to be developed as part of the banks' strategic and business plan. In this context, a market analysis might be critical to the success of the strategic plan and vital for the proper execution of the business plan.

33. In each bank, in conjunction and congruent with the strategic plan, the management would need to

⁶¹ Page 113 of the Operational diagnostic review reports.

complete a detailed marketing plan and each of its business units covering, as the case may be, new product introductions, service innovations and improvements. These plans should include: (i) a definition of market objectives; (ii) an analysis of market targets, products, and growth rates and shares; (iii) an analysis of customer needs, and marketing image of the Bank and its services; (iv) a marketing “strengths, weaknesses, opportunities and threats” analysis for the Bank; and (v) a plan of organization of marketing and sales at head-office and branch levels.

34. In particular, the banks’ management will have to make sure that business units are defined to meet the requirements of customers and the achievement of the banks’ strategic goals. For instance, the assessment could be made as to whether there is a need for relationship or account managers to handle major clients, the different organizational arrangements required for retail, small corporate, private sector clients or the possible requirement to set up specialist units for individual product areas.

35. The banks’ management will have to ensure that skills needed for market analysis and planning, and help institute a formalized market planning and development process within the framework of the banks’ strategic planning process are in place. The management of the banks will have to define: (i) a training program regarding the banks’ marketing strategy and methods of sales and customer service; and (ii) an advertising and public relations program.

K. Human Resource Management and Training

36. For both public banks, the operational diagnostic review report show that the current situation raised major issues in terms of human resources practices. There is no clear manpower plan (recruitments are conducted spontaneously based on number of authorized vacancies) and no consistent selection criteria⁶², no performance management system.⁶³ There will be a need to assess the banks’ human resources and their adequacy for commercial banks operating in a competitive environment. Following the assessment of the adequacy in terms of staff skills, recommendations may be needed to address identified deficiencies in light of the banks business strategy and business focus and plans. To this end, a comprehensive training needs analysis will be required and a formalized training (and as needed recruitment) plan⁶⁴ should be established..

37. A human resource management system will have to be put in place in both banks to meet both current and future human resource requirements. There will be a need to address: (i) first the banks’ immediate needs for building critical skills and efficiently deploying the work force to staff its new organization, and support the execution of its strategy and business plan; then (ii) the banks’ medium-term needs for developing and managing its human resources.

38. Rafidain Bank and Rasheed Bank will need to implement a first set of high-priority human resource management systems consisting specifically of: (i) a training needs analysis; (ii) a training and development master plan, including a prioritization and planning of how all training needs will be met, and the launching of highest priority programs; (iii) a performance appraisal system, including the assessment of the performance and potential of employees, and the identification of major development needs; and (iv) a staffing program which entails the effective matching of people to jobs in the revised organization structure.

39. The banks’ next order of priority is to build, implement and train staff in applying the human resource management systems, related to: (i) manpower planning, covering supply and demand analysis, projection of manpower gaps and excesses (over 2 to 4 years) by major skill and rank level, and plans to fill

⁶² Page 120 of the operational diagnostic review reports.

⁶³ Page 125 of the operational diagnostic review reports.

⁶⁴ Page 127 of the operational diagnostic review reports.

the gaps and deal with the excesses; (ii) recruitment, with pro-active methods for finding and selecting key talents; (iii) rewards management, along a compensation scheme that will attract, retain and motivate managers, technical personnel and staff; (iv) management development, with methods for developing general and technical managers; (v) performance management, through an effective system for managing individual performance (e.g., goals, standards, monitoring, evaluation); and (vi) work culture development, under a program for building a competitive, commercial work culture throughout the organization.

40. These steps will include documentation of each system in the form of an operating manual, as well as pilot implementation and training of implementation staff. In particular, as needed, the management of the banks will be responsible of conducting on-the-job training for the staff so that the banks have the full ability to carry on the work in the future. The management may set as a priority – although this would have to be based on the training needs analysis – the focus on two selected and critical groups of managers: (i) branch managers, where training should cover *inter-alia*, business planning, profit and cost management, human resource management, management control and marketing; and (ii) head-office department directors, where training should cover *inter-alia*, business and staffing planning, profit and cost management, human resource management, change management, performance monitoring and measurement.

II. Output

41. The management will work with the board of directors of the banks to develop, along the specifications of the framework outlined in this note, the following program: (i) a strategic plan; (ii) business plans for individual business units; (iii) an organization structure; (iv) a budgeting and performance measurement framework; (v) identification and framework design of required management information systems; (vi) automation and technology support program; (vii) accounting and internal audit processes; (viii) implementation of a credit risk management process with emphasis on management of problem loans; (ix) implementation of asset and liability management systems for significant non-credit related risks; (x) development and initial implementation of plan for marketing of the Bank's products and services; and (xi) human resource management and training program including the implementation of priority human resource management systems.

42. It is recommended within this framework that performance indicators be established to assist in monitoring achievements.

ANNEX 7. BANKING REGULATION AND SUPERVISION PROGRAM

- 1. The strengthening of the regulatory and supervisory framework in the banking sector is a critical part of the banking reform program.** A credible, independent regulator is the necessary anchor of an effective and resilient banking system, especially in an environment where state ownership of banking institutions is significant (state ownership accounts for nearly 90 percent of the banking sector assets at the end of 2006).
- 2. Since 2004 the CBI has embarked on a comprehensive program of capacity building covering extended areas of the regulatory and supervisory functions, as it is seeking to move from compliance to risk-based supervision.** The IMF has been providing assistance to the CBI since end of 2004 and has done considerable work in helping Iraq develop a banking regulatory and supervisory system, in line with best international standards and practices. In coordination with the Federal Reserve System, training workshops were conducted to promote the emergence of a core group of professional banking supervisors among the existing CBI staff. Between June 2004 and January 2006, the IMF carried out an initial cycle of classic training workshops aim at acquiring basic knowledge in banking supervision. Then the capacity building exercise shifted replicating the work of a resident advisor in reviewing the actual work and outputs (on site inspection report, off site analysis note etc..) produced by Iraqi supervisors, and in providing them with feedback and guidance for off-site and on-site supervision. This is closely coordinated with, and complements the work of, the Baghdad-based U.S. banking supervision experts and the METAC experts based in Beirut. Now, the IMF TA is evolving to be demand-driven and consisting of specific issues identified by the CBI. The next workshop is scheduled in January 2009 and will focus on topics to be selected by the CBI supervisors.
- 3. To be effective the TA should be based on a thorough and comprehensive review of on-site and off-site processes at the CBI.** An organizational restructuring of the banking supervision function should be carried out to set up or enhance the core functions in banking supervision such as On-Site Inspection, On-Going Surveillance, Licensing, Macro-prudential Analysis and Regulation and Enforcement. As a result, the banking supervision in Iraq would move from compliance to a more proactive and modern risk-based supervision.
- 4. The CBI should start new recruitments to rejuvenate the work force.** Notwithstanding their good education background, these newcomers would need training and incentives, while a new culture based on efficiency and achievements needs to be built. To this effect, the entire banking supervision training policy and process would be evaluated to assess if the training programs are congruent with and responsive to the needs of the banking supervision. Training would also be useful for management to enhance leadership capacity.
- 5. When security permits, on site inspection should focus on risks.** Increased attention should be directed to credit organization and policy, concentration of credit, source of funding, risk management system, IT system and internal controls. On site process should be upgraded to meet the risk-based supervision requirements: (i) before the mission in sharing information with off-site supervision and the macro-surveillance unit; during the mission in staffing the team with relevant people (especially regarding IT); and (ii) after the mission in setting up a collegial body for reviewing the inspection findings, and dealing in full transparency with inspection follow-up and enforcement. The CBI should also develop guidelines to conduct standardized on-site examinations. Generally, on-site surveillance also gained greater efficiency by sending to the concerned parties an “introductory letter” that aims at gathering the relevant data and information before the on-site examinations start.

6. **The CBI should provide the inspectors with new IT tools giving them access to databases from On Going Surveillance.** On-site examiners should use those tools to run their credit risk controls and the inspection teams will have to update the database with the data collected on the field. This type of feedback will help strengthen and improve the On-Going Surveillance reports credit institutions along a CAMELS based approach.

7. **Inspection teams need more trained personnel, particularly in the fields of IT and on a medium term basis market risks.** This new working environment would make significant progress on credit risk analysis which is the main risk of the banking system in Iraq. However old habits die hard and it will take some more time to move from a compliance approach to a fully risk-oriented banking on-site monitoring where qualitative assessments on bank's functioning complements the compliant approach. Continuing training sessions should be planned for the next months in various aspects of the on-site examinations and especially to better assess bank strategies and risk management systems.

8. ***A new IT system should help On Going Surveillance focus on critical issues for an enhanced decision making process.*** A new IT system would need to be implemented on a timely basis to increase efficiency and productivity. More specifically, the CBI would analyze the IT supervisory needs (hardware, software, protocol for data collection and data administration, etc.) including the possibility to store all official banking financial statements. In addition, both on site, and off site supervision must work together to create a continuous, seamless supervisory cycle. The off site supervision must also develop new tools to focus on critical issues for an enhanced decision making process (peer comparison analysis, Camels' model analysis, Early Warning System etc...). To this purpose, the CBI has to redesign the framework of the supervisory information flow and build a new MIS. With a new IT system being implemented at the CBI, a risk-oriented report regarding the strategy and the overall performance of a credit institution could be worked out. This CAMELS typed approach report would constitute a comprehensive review of the banks. Produced on an annual basis, those reports will cover all risks inherent in the bank's activities, including both quantitative (key figures regarding the bank's financial position, based inter-alia on the yearly balance sheets and profit and loss accounts, along with peer comparisons, market shares) and qualitative information (facts about main shareholders, description of the main business activities, corporate governance, analysis of the earnings sustainability, solvency, liquidity and market risks). In a nutshell, this annual report is designed to convey the banks' overall risk profile.

9. ***A macro-prudential surveillance unit should be set up in a financial stability perspective.*** . The key deliverable for this unit would be an annual Banking Sector Review. This review would deliver a comprehensive analysis of the banking sector in dealing with macroeconomic and financial markets developments, banking sector structure, earnings and profitability, capital adequacy, asset quality, liquidity and other risks, and regulatory and supervisory developments. Its purpose is to address the key developments, risks and vulnerabilities, as well as the assessment on the resilience of the Iraqi banking sector. This initiative, in line with the Basel best practices aims at enhancing the market discipline, thanks to a greater disclosure of the banking sector issues.

10. **All those elements should, in the long run, help the CBI develop an Early Warning System enabling an adequate, proactive framework to deal with problem banks.** In particular, it should help the CBI in determining the levels of capital ratios as well as best suited remedial measures to address particular events or risk profile of credit institutions. In addition to the work already accomplished, a broad range of analysis may be needed to assess the banks capital and their ability to sustain non expected losses, assuming that their provisions would be sufficient to cover the expected losses. The CBE should also formalize transparent guidelines on crisis management to deal with problem banks. It would include taking control of a bank in distress, imposing a moratorium, restructuring the bank's liabilities,

transferring all or part of its business to another bank or to a special purpose entity, and providing lender of last resort facilities.

11. **Since the end of July 2008, as part of the new Stand-By Arrangement (SBA) with the IMF, Iraq has completed a first set of prudential regulations⁶⁵ for commercial banks.** In line with the new regulation underway, banks, especially public sector banks⁶⁶, would have to improve their credit risk policies and develop systems for extending credit, reviewing and classifying loans, and defining realistic provisioning needs. Regarding connected and directed lending, measures should be taken to ensure that banks have in place an independent decision making process that would preclude conflicts of interest and enforce arms length lending policies.

The main issues are reviewed thereafter.

12. **(a) Lending policy.** The CBI has to vet fully the implementation by the banks of their lending policies. These lending policies have to be comprehensive, prudent, and consistent with a sound management of bank's activity. Furthermore, it is crucial to assess the skills and knowledge of the staff in charge of credit approval, and check if banks have adequate systems to control and monitor the implementation of such policies.

13. **(b) Loan evaluation and loan loss provisioning.** The new classification will improve the accurate knowledge of the bank loan portfolio. For the implementation of the new classification of loans, training sessions are needed for credit officers and banking supervision examiners. This implies also that banks have in place a credit organization and credit management systems in compliance with the new regulation (in particular, a good credit administration). As a result, banks have to improve their systems for granting credit, for reviewing and classifying loans, and for determining realistic provisions. The main outstanding issues relate to how to get from companies accurate, and up-to-date financial statements with all needed information.

14. **(c) Large exposure.** The aggregation of all the large exposures must not exceed eight times the capital base. It is necessary to provide banks with an extensive definition of close related parties. Banks must in a comprehensive way identify and monitor credit exposures to closely related groups on the basis of such specific guidelines.

15. **(d) Connected and directed lending.** Procedures must be set up to prevent persons benefiting from a loan from participating in the preparation of the loan assessment or in the related decision-making process. These loans have to be approved by the Board of directors. Banks have to develop risk management rules, procedures and information systems for lending to connected parties in order to avoid conflicts of interest. The new regulation should also address directed lending with regards to state-owned banks in particular. In addition, specific guidelines should be issued to improve corporate governance in public banks and ensure that loans are made on the basis of borrower creditworthiness and debt service capacity

16. **(e) Internal control and audit.** As CBI cannot rely only on the external auditors since the quality of their report is uneven, internal control regulation system appears to be critical. CBI would need to enhance the quality of internal control and audit in banks and ensure bank's top and middle management

⁶⁵ This included: (i) licensing requirement processes; (ii) minimum capital requirements; (iii) loan classification and provisioning; (iv) large exposures; (v) connected lending (transactions with related parties); (vi) investment in securities and real estates; (vii) lending policy; (viii) internal control; (ix) compliance function; and (x) risk management.

⁶⁶ A banking restructuring action plan would support Rafidain and Rasheed banks in redesigning and implementing a new risk management process.

commitment to the process. CBI would need to support through specific guidelines what is an accurate and comprehensive internal control system based on risk management. Consolidated supervision would also need to be enhanced and brought in line with international standards. The setting up of a legal and regulation unit with particular skills in the legal and accounting fields would be instrumental.

17. Under the second set of the prudential regulations, efforts should be directed to implement a new framework for addressing operational risk and related issues, and market risks. Currently, there are no guidelines from CBI to ensure that banks have in place procedures and systems for identifying, managing and monitoring operational risk. In this regard, the CBI has to develop specialized IT examinations focusing on areas such as information system management, computer operations, computer security, system development and networking, for fighting against fraud and keeping safe the business activity. Existing policies and practices for inspection should be updated to become forward-looking and risk-based with a focus on new issues such as operational risk and internal controls. On a medium term basis, developments of financial markets would call for taking steps to control market risks. There are still no limits to equities trading and investment, and no guidelines for banks to deal with these risks, notably in stress testing. Capital adequacy ratio does not take into account market risks. Regarding the FX and interest rate risks, CBI has to ensure that banks have in place adequate information systems to identify accurately these risks. In coordination with IMF banking supervision experts, CBI has to propose regulation amendments or new rules when appropriate.

ANNEX 8. IRAQ BANKING REFORM STRATEGY—ACTION PLAN*
(2008-2012)

I. ORGANIZATION STRUCTURE

A. Develop an Overall Organization Structure

- Business Units organization** (retail, corporate and investment banking, and other business units)
- Risk Management Units
- Management Information System
- Governance, Control and Support Units (audit, legal & compliance, anti-money laundering, human resources & organization, shared services, financial functions, risk functions)

B. Forming a Dedicated Restructuring Unit Headed by a Restructuring Project Officer in Individual Banks

II. CAPACITY BUILDING

A. Improve Human Resources Processes (development of a people strategy, clear rules and regulations for employees, assessment of skills and needs, job descriptions and qualifications and career paths, rewards management and performance evaluation)

B. Training of Staff Based on a Detailed Training Plan (skills and talent development, role modeling, increasing understanding and motivation, mindset and behavior transformation)

III. FINANCE AND ACCOUNTING

A. Restructuring the Balance Sheets (including inherited debts and losses)

B. Capital Adequacy (classification of assets and provision policy, capital base)

C. Budgeting, Planning and Performance Management

D. Accounting System in Compliance with National Standard and in-line with International Practices

E. Comprehensive Reporting System of Financial Results

F. Cost Recovery and Re-pricing of Financial Products

IV. IT INFRASTRUCTURE

A. IT Platform Covering all Operational Aspects, including:

- Marketing and sales tools
- Credit tools
- Risk management tools
- IT Related Consumer Product

B. Connectivity of Branches and Supervision Authority—Flow of Information

C. Security System of Information

V. RISK MANAGEMENT

A. Credit Risk (origination, underwriting, monitoring, workout)

B. Non-Credit Risk Management (market risk, operational risk, etc.)

VI. INTERNAL AUDIT AND COMPLIANCE

A. Internal Audit (processes, audit framework and methodology, effectiveness of internal audit)

* Banks in this Annex refers to state-owned banks.

** Units in this document refer to any organizational form.

- B. Compliance with Laws, Regulations and Instructions** (scope of improvement, compliance framework and methodology, organization)

VII. STRENGTHEN THE BANKING SUPERVISORY AND REGULATORY AUTHORITY

- A. Make a Thorough and Comprehensive Review of Banking Supervision Processes**
B. Update and Enforce a set of Regulations in line with International Standards
C. Make New Recruitments and Develop Training

I. ORGANIZATION STRUCTURE

A. Develop an Overall Organization Structure

Start Time: July 2009

- Review the “as is” overall organization structure (hierarchical structure, roles and responsibilities, risk management, revenue sources) and detect the main current organizational issues.
- Design the bank new target model fulfilling: (i) hierarchical structure simplification in order to speed up decision making processes; (ii) focus on risk, business and accountability; (iii) neat separation between risk generation and risk control/monitoring; and (iv) neat distinction between revenue generating units and supporting/shared services units
- Adopt the new organization structure.
- Create the Restructuring Units
- Identify and hire Heads for key priority functions
- Design the migration plan from the “as is” to the new organization

1. Business Units Reorganization

a. Retail Business Unit

Start Time: June 2009

- Create the position of “head of Retail” who will be responsible for: (i) retail products (deposits and other liability products, credit cards, personal loans, mortgages, etc.); (ii) retail client segments (i.e. affluent, mass market and micro-business; and (iii) branch network
- Create separate units for marketing.
- Consolidate branch network management under one Head (or a number of regional managers) to report directly to the Head of Retail

b. Corporate Business Unit

Start Time: September 2009

- Create the position of “Head of Corporate & Investment Banking” who will be responsible for the development and management of the Corporate Business (small, middle and large corporate segments)
- Create the “Trade Finance” Unit.
- Decide on integrating investment banking with corporate banking or creating an Investment Banking Unit (as is desirable)

c. Other Business Units Organization

Start Time: December 2009

Under the Treasurer:

- Review Treasury front office activities
- Review Treasury back office activities
- Create Credit Workout Unit to be responsible of non-performing loan analysis, recovery strategy, debt recovery “execution” and performance assessment (*See Section IV and V for more details*)

2. Risk Management Units

Start Time: July 2009

- Create Risk Management Units (*See Section V for more details*)
- Create the position of the Chief Risk Officer who will be reporting to senior management and responsible for: (i) risk policy (credit, market, operational risk, portfolio, etc.), and risk control (credit, market, operational

risk, portfolio, etc.); (ii) risk measurement (credit, market, operational risk, portfolio, etc.); and (iii) other risk related functions

3. Management Information System

Start Time: December 2008/January 2009

- Risk Management Unit will be responsible for: (i) central NPLs database; (ii) simplified and standardized rating/scoring tool; (iii) standard and centralized system and database for customers pre-screening; (iv) control of limits; (v) simulation of capital absorption on new deals; and (vi) simulation of market risks and capital needs

4. Governance, Control and Support Units

Start Time: January 2009

a. Audit

- Revisit audit organizational structure to ensure that it covers The bank control system (i.e. IT, financial and branch network auditing) and clients' claims management

b. Legal and Compliance

Start Time: January 2009

- Revisit compliance organizational structure.
- Increase number of compliance staff for understaffed areas

c. Anti-money Laundering

Start Time: January 2009

- Revisit the established Anti-money Laundering Units in individual banks to ensure compliance with the Anti-Money Laundering Law and CBI regulations

d. Human Resources and Organization

Start Time: January 2009

- Enhance the position of "Human Resources Head" who will be responsible for: (i) human resources development and management (selection, evaluation, training, incentive system and career paths); (ii) bank organization; and (iii) internal communication

e. Shared Services

Start Time: January 2009

- Create the position of the Chief Operations Officer who will be responsible for the management of shared services provision to the Bank's business units, in order to maximize effectiveness and efficiency
- IT application, processes, back office services, real estate and facility management, purchases and logistic)

f. Financial Functions

Start Time: January 2009

- Create the position of the Chief Financial Officer who will be responsible for: (i) planning and control; (ii) funding and asset and liability management; and (iii) accounting, financial reports and tax management

B. Forming a Dedicated Restructuring Unit at each Individual Bank

1. Establish a Dedicated Restructuring Unit Headed by a Restructuring Project officer in Individual Banks:

Start Time: January 2009

- Create the position of the Head of the Restructuring Unit for each bank
- Follow-up and coordinates across different working groups on operational, institutional and financial restructuring of the bank
- Reports to the bank management and Executive Restructuring Committee
- Produce monthly and quarterly reports on progress made and challenges confronting the implementations of the restructuring process

II. CAPACITY BUILDING

A. Improve Human Resources Processes

1. Development of a People Strategy

Start Time: On-going process

- Define clear roles and responsibilities for human resources management processes

- Leverage bank’s strategy to develop a comprehensive “People Strategy”, including: (i) an agreement on type and number of employees needed; and (ii) an agreement on strategic people choices (i.e., talent acquisition, work and accountability, performance metric and employee value proposition)
- Develop a plan to address redundant staff through redeployment or voluntarily early retirement schemes
- Clarify the rules and regulations applicable to employees of state-owned banks

2. Assessment of Skills and Needs

Start Time: July 2008

- Evaluate current level of skills, especially for pivotal roles (such as workout officers and Credit Marketing Officer) and managerial positions (including network)
- Assess commercial (such as product information) interpersonal and analytical/technical skills of sales force
- Identify recruitment needs for specific positions
- Create new job openings in areas that are not adequately available in banks with the needed skills, (such as chartered accountant, certified FM, IT expert, credit officer, credit risk management, mortgage underwriting, sectoral analyst, etc.)

3. Job Descriptions, Qualifications and Career Paths

Start Time: July 2008

- Define specific and action-oriented job descriptions starting with pivotal positions in both Head Quarters and network; ensure that the responsibilities/ accountabilities are clear and well-understood
- Identify career paths for different positions including changing requirements/expectations at milestones

4. Reward Management and Performance Evaluation

Start Time: June 2008

- Improve performance evaluation system to ensure objectivity and to include Value Based Management indicators
- Leverage on the work of the Ministry of Finance and the banks on “The Incentive Structure for Management and Employees Program”
- Revisit level and variability of incentives for specific positions (e.g. Marketing Officer, Workout Officers, etc.)
- Agree on style of accountability
- Collaborate with Value Based Management leaders to define process for setting goals and monitoring results
- Evaluate performance based on defined process
- Agree on compensation and rewards
- Find suitable solution for employees with low performance and potentials

B. Training of Staff Based on a Detailed Training Plan

1. Skills and talent development

Start Time: January 2008

- Launch an extensive training starting from pivotal areas and roles: (i) key training areas would include FM, risk management, credit analysis, compliance, marketing, tellers with IT capabilities, etc.; and (ii) key marketing roles (such as credit marketing officer) would include four dimensions: technical knowledge (including, product knowledge), management capability, leadership and communication skills (including sales attitude)
- Set up a training program to increase experience and international competence preferably in partnership with foreign banks and/or institutions (such as exchange programs); provide support for development programs such as masters degree and language courses

2. Role Modeling

Start Time: January 2008

- Deeply involve the top management in explaining the overall missions and strategy as well as the targets and objectives
- Find pivotal people and make them the “champions” of the behavioral change.
- Define the characteristics of a high-performing “top team” and the main steps for transformation paths
- Define seminar program held by top management for explaining to employees overall mission, strategy, targets and objectives and stage leadership “symbolic acts” as appropriate

- Identify the top 100-300 leaders to be indicated in future as role models (e.g. charismatic Branch/ Line managers).
- Highlight “change champions” characteristics from all levels in both formal and informal leadership roles.
- Training workshops with these pivotal people to make them “champions of change” within their daily work

3. Increasing understanding and motivation

Start Time: January 2008

- Arrange recurring meetings between head quarter people and branch network to illustrate strategy and commercial initiatives.
- Establish a task force to help network in implementing commercial initiatives and new sales behavior
- Conduct regular meetings for feedback

4. Mindset and Behavior Transformation

Start Time: January 2008

- Conduct full diagnostic of the Bank’s culture/needs
- Conduct a program targeting mindset & behavior as well as other capability needs, including:
- Design program and prepare training modules for key business and control areas and roles
- Conduct off-site training modules targeting different profiles (e.g. front line staff, branch managers, etc.)
- Conduct intense technical/ commercial workshops for front line staff
- Launch a training program designed to select top performers for future programs, by closely monitoring performance of participants
- Measure impact of programs and agree on improvement opportunities for future programs

III. FINANCING AND ACCOUNTING

A. Restructuring the balance sheets (including inherited debts and losses)

On-going process

- Define foreign debts of banks in accordance with the aim of reflecting the foreign debt settled in the banks’ financial statements
- Transfer to the Ministry of Finance or establish contra-accounts
- Ministry of Finance would take responsibility of part of the external debt
- Ministry of Finance will negotiate for the remaining portion of the external debt with relevant parties
- Define other debt and losses for making related decisions by authorized parties
- Identify and agree on discrepancies and ways to eliminate undercapitalization of banks
- Monitoring of banks’ foreign assets in foreign banks and foreign correspondents

B. Capital Adequacy

On-going process

1. Classification of assets and provision policy

- Increase the amount of provisions in the profit and loss (P&L) in compliance with the audit results
- Provide additional resources by the Ministry of Finance to the banks to be used for provisioning for NPLs
- Account for NPLs that are not recognized in the current accounts

2. Capital base

On-going process

- Reevaluation of the banks’ assets and take decision regarding non-strategic investments, rationalizing real estate properties of the bank in order to reduce the risk-weighted assets base

C. Budgeting, Planning and Performance Management

Start Time: June 2009

- Leverage on the findings and recommendations of Ernest & Young audit in order to design a short-term Annual Business Plan and long-term “Strategic Business Plan” for each bank: (i) overview market outlook; (ii) assess bank current position; (iii) define bank’s mission, strategic priorities and aspirations; and (iv) define implementation approach, progress monitoring process and tools
- Improve operational planning and budgeting: (i) diagnose current situation and align different stakeholders; (ii) design a new operational plan and budgeting concept; and (iii) testing, piloting and deployment of the process

- Design a value-based management approach: (i) define Key Performance Indicators and value drivers; (ii) create a performance planning system and set opportunity based targets; and (iii) create a controlling function

D. Accounting System in compliance with National Standards and in-line with International Standards

Start Time: January 2009

- Restructure general ledger
- Map and redesign accounting processes and policies
- Define system to account for provisions
- Leverage on the work being done to identify and clarify foreign debt, inherited losses and provisions

E. Comprehensive Reporting System of Financial Results

Start Time: June 2009

- Define a set of data that is critical to the Ministry of Finance, the CBI, the management of the banks, and investors
- Identify financial performance indicators
- Take the required steps and measures to make the data available to decision makers and public

F. Cost Recovery and Re-pricing of Financial Products

Start Time: March 2009

- Inventory of the major financial products and services, including potential new products
- Reassessment of the costs of financial products and services including those provided to the public sector to ensure that these costs cover capital costs
- Establishing a streamlined mechanism of the procedures and steps required to authorize pricing of financial products and services

IV. IT INFRASTRUCTURE

A. IT Platform Covering Accounting and all Operational Aspects

1. Establish IT Platform

Start Time: October 2008

- Implement an IT system that handles basic transactions of the banks.
- Expand the capability of the system to provide a timely picture of the banks position.
- Design interim templates in key areas, such as: (i) credit tools in the areas of pre-screening, scoring, early warning and NPLs transparency; (ii) tools to target manage and monitor sales (reports on products usage, risk profiling, etc.); and (iii) corporate segmentation based on real business parameters such as turnover, number of employees and asset size
- Design IT related consumer products, such as swift, credit cards, automatic teller machines, direct deposits of pay, etc.

B. Connectivity of Branches and Supervision Authority

Start Time: October 2008

- Set-up connectivity between branches and Headquarters in Baghdad
- Set-up connectivity between branches and Headquarters in other Governorates in Iraq
- Set-up connectivity with all correspondent banks
- Set-up connectivity with head quarters and the CBI

C. Security System for Information

Start Time: June 2009

- Adopting a security system for information in compliance with international standards
- Defining the responsibilities and authorities of those who have access to the system
- Identifying the right caliber, ethical, and professional skills for the staff responsible for the security system of information
- Establish a disaster recovery system

V. RISK MANAGEMENT

A. Credit Risk

1. Origination

Start Time: October 2008

- Revise credit policy to make it simple and shared across the organization, setting guidelines on the credit risk appetite of the Bank and on how credit Risk should be distributed (across segments, sectors and geographies)
- Define how the overall process (of deciding, announcing, monitoring and revising credit Policy and strategy) works by specifying roles and responsibility of different stakeholders (i.e., Board, sales force as well as Credit Risk control units)
- Develop risk management policies and regulations for credit risk
- Transform front-line credit sales force from reactive to pro-active, increasing their focus on the client service while at the same time improve their level of accountability
- Reduce credit concentration risk
- Design standard and system/database for pre-screening (initially even basic parameters such as turnover, number of employees, past transactions, etc.), support organization with industry- specific data and information, such as sector reports
- Assess current situation by: (i) collecting credit files of all corporate and small and medium enterprises customers; (ii) assessing credit risk distribution (e.g., risk-adjusted exposure or, in absence of it, nominal exposure) across sectors and geographies; (iii) assessing risk rating and credit strategy of all corporate customers and most significant exposures (for example small and medium enterprises), and (iv) identify the weaknesses
- Define a risk-adjusted pricing for lending products
- Review credit policy/strategy
- Developing a simple credit strategy leveraging on existing material: (i) setting guidelines on Bank credit risk appetite and on how credit risk should be distribute across sectors/geographies
- Evaluating the new system
- Define a program to improve sales force and effectiveness: (i) create client portfolios to be allocated to sales force; (ii) define basic performance measurements (commercial, revenue and risk indicators); (iii) develop recruiting and training requirements for sales fore and credit officers; and (iv) plan the roll-out of the training program
- Develop business requirements to the IT for a centralized pre-screening tool supporting information reports (e.g. sector reports)
- Understand whether target IT platform fully satisfies/meets the business requirements

2. Underwriting

Rating and Scoring:

Start Time: January 2009

- Simplify and standardize rating/scoring mechanism and tools, ensure that all credit-related employees understand and use them
- Design the systems to integrate all applications and database across the whole process and locations
- Standardize data requirements at the front-line level to minimize back-forth between origination and underwriting
- Closely monitor discrimination power of the scoring mechanism for further improvements
- Closely monitor customers ability to repay any loans in foreign currency

Delegated Credit Powers:

Start Time: January 2009

- Revise the overall credit processes designing a workflow and a set of powers (based first on lending exposures and over time on risk) which will allow quick response to clients and optimize the workload of the Board, Credit Committees and other organization levels involved in credit underwriting
- Degree of delegation will depend on the size of the exposure

3. Monitoring

Diagnose the “as is” and Draft the Operating Model:

Start Time: March 2009

- Review Current model and identify gaps versus best practices
- Develop a full diagnostic on processes: (i) watch-list selection and prioritization; (ii) preparation and implementation of pre-specified actions towards companies in the watch list; (iii) risk re-rating policy and procedures; and (iv) assessment of predictive power of current early warning model
- Develop a full diagnostic on organization: (i) responsibility split between head office and branches; and (ii) role split between credit officers and Credit Marketing Officers
- Design the operating model to be implemented (with clear responsibility split between head office and branches as well as between credit officers and Credit Marketing Officer) and review the dedicated units

Capture Quick Wins and Design the Change:

Start Time: March 2009

- Identify and launch quick wins: (i) create and review the watch list and its prioritization; (ii) prepare an action plan towards companies in the watch list; (iii) select and train a task force (composed of high potential employees with credit expertise) responsible to manage/update the watch list; and (iv) develop an easy to use and effective tool (i.e. excel format) to monitor the large corporate loans according to certain parameters and pre-set warning criteria
- Define a new loan monitoring process (e.g. process description of watch list selection, composition and prioritization, action plan design and implementation)
- Improve monitoring organization: (i) define official role description of all the parties involved in the monitoring process (credit risk monitoring statistics, RMS, credit officers); and (ii) design a new performance measurement and incentive system
- Design required supporting system: (i) develop business requirements for an early warning system; and (ii) develop business requirements for a workflow system and attached standard reports
- Ensure that the IT platform to fully satisfies/meets the business requirements

4. Workout

Short-term Initiatives:

Start Time: March 2009

- Analyze current existing portfolio: (i) establish a central NPLs database to enable portfolio segmentation in order to better identify relevant credit customers; and (ii) analyze historical recovery over last year and total cost of credit (losses, financial and operating costs): closed NPLs files sampling and one year recovery analysis of open NPLs Review current performance by customer segments
- Identify and launch “quick wins”: (i) draft a list of prioritized credit files according to net present value of recovery, distinguishing across segments and across secured vs. non secured lending, (iii) select and train a task force (composed of high employees with credit expertise) to workout selected NPLs; (iii) design the task force organization structure and its “ad hoc” incentives system; (iv) define simple and standard reports to make performance transparent and easy to monitor (at both aggregate and officer level); and (v) review the set of authority limits and delegated powers so as to speed up decisions and settlement process
- Develop recovery strategy and processes by customer segments (e.g. cases allocation to recovery officers, required level of analysis, key performance indicators)

Long term Initiatives for Sustainable Performance:

Start Time: March 2009

- Design the long term operating model and define the organization structure specifying: (i) credit categories (i.e. Corporate, small and medium enterprises, Retail) and if necessary, sub-segments (i.e. geography and/or industrial sector); (ii) criteria to allocate credit to workout unit; (ii) criteria to allocate credit portfolio to workout officers; and (iii) processes and systems
- Develop a recruiting and redeployment plan, both for internal and external resources, according to the requirements in terms of full time equivalent and skills
- Define a training program for the workout officers
- Define an incentive system based on the recovery performance
- Estimate economic and financial impact of the long term business model

- Develop business requirements for a decision support system, with the following characteristics: (i) centralized and electronic access to the required data; (ii) support to the recovery agents in identifying recovery strategies; and (iii) decision making support based on quantitative indicators (i.e. recovery rate, average time of recovery, cost per transaction, etc.)

B. Non-credit Risk Management

Start Time: March 2009

- Implement basic risk management in terms of measurement, strategy, processes and systems: (i) introduce simple risk adjusted profitability measurement; (ii) define basic capital allocation and expected return on capital; (iii) define risk management strategy and processes (e.g. operating limits and risk control processes); and (iv) introduce simple systems- or prototypes in short term- to support risk measurement of portfolio positions, control of limits and simulation of capital absorption on new deals
- Develop a full diagnostic to assess in an objective and consistent way each area of risk management.
- Design corporate risk management function with clear description of roles and responsibilities: (i) provide high level job description and key performance indicators for all functions related to risk and its processes
- Define guidelines on risk by the business unit and by risk type
- Define metrics for risk-adjusted performance measurement for the different levels of the organization
- Define a capital allocation process, coherent with the business and growth aspirations; set targets for expected returns taking risk into account; and allocate capital
- Define control processes to monitor operating limits and specify proper actions for managing exceptions
- Define business requirements of new systems/prototypes to support: (i) risk measurement of portfolio positions; (ii) control of limits; (iii) simulation of capital absorption on new deals

1. Market Risk

Start Time: March 2009

- Create Market Risk Management organization
- Review of treasury processes
- Liquidity risk measurement and management.
- Interest rate risk measurement and management
- Funds Transfer Pricing

2. Operational Risk

Start Time: March 2009

- Define operational Risk organization and methodology
- Set up Operational Risk reporting and control
- Define key performance indicators and standards of control
- Outline Operational Risk Management manual
- Set up Risk and Control self assessment
- Design new product approval process

VI. AUDIT AND COMPLIANCE

A. Internal Audit

1. Processes, Audit Framework and Methodology, and Effectiveness of Internal Audit

Start Time: March 2009

- Evaluate the audit process, including role of Audit Committee, and recommend necessary improvements
- Create an integrated audit assessment frame work and methodology
- Assess effectiveness of internal audit, including the technical expertise, qualifications and experience in the internal audit function in order to provide assistance in all areas of the business
- Evaluate and assess effectiveness of the audit process and recommend necessary improvements of: (i) mission; (ii) roles and responsibilities; (iii) staffing (number of employees); (iv) skills (technical expertise, qualifications and experience); (v) supporting tools; and (vi) Key Performance Indicators
- Create an integrated audit framework and methodology
- Review and define Audit roles and processes (e.g. mission, roles and responsibilities, staffing, skills)

- Define a migration plan towards the “optimal” Audit structure, (e.g. supporting tools, key performance indicators)

B. Compliance with Rules, Laws, Regulations and Instructions

Start Time: March 2009

- Assess current areas of improvement (e.g. understand role of the current Compliance Unit, benchmark with international players)
- Strengthen compliance function: (i) revisit compliance framework and methodology (activities, regulation, policies) and the boundaries with audit and other functions; (ii) revisit organizational structure (e.g. define head role and responsibilities, review reporting lines, increase number of compliance staff in understaffed areas, define skill level requirements); and (iii) increase compliance-related IT investments (management information system, transaction monitoring, etc.)
- Run a compliance mindset and behavior program for both frontline and compliance officers, e.g. training programs, communication programs, and incentives and rewarding scheme.

VII. STRENGTHEN THE BANKING SUPERVISORY AND REGULATORY AUTHORITY

A. Make a Thorough and Comprehensive Review of Banking Supervision Processes

Start Time: January 2009

- On site supervision should focus on risks: (i) credit organization and policy; (ii) concentration of credit; (iii) source of funding; (iv) risk management systems; (v) IT system; and (vi) internal controls.
- Off site supervision should focus on: (i) new Management Information System; (ii) comprehensive review of banks (CAMELS approach); (iii) qualitative and quantitative analysis; and (iv) Peer comparison analysis
- Macro prudential surveillance should focus on resilience: (i) key developments, risks and vulnerabilities of the banking sector; (ii) seamless supervisory cycle with micro prudential surveillance; and (iii) main delivery: annual banking sector review

B. Update and Enforce a Set of Regulations in line with International Standards

Start Time: January 2009

- Priorities of the first set of regulations: (i) implementation of a lending policy; (ii) accuracy of loan evaluation and improvement of loan loss provisioning; (iii) monitoring of large exposures; (iv) addressing connected and directed lending; and (v) enhancement of internal controls and audit
- Priorities of the second set of regulations: (i) operational risk and related issues; and (ii) market risks

C. Make New Recruitments and Develop Training

Start Time: January 2009

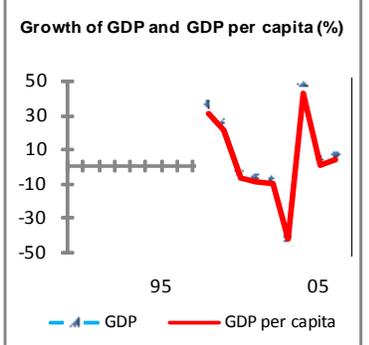
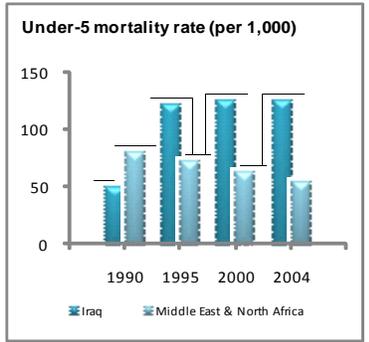
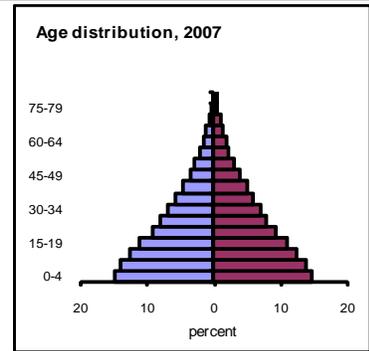
- Staff and training issues: (i) start new recruitments to rejuvenate the work force; (ii) assess the training policy and process; (iii) enhance leadership capacity and rewards; and (iii) incentives and rewarding scheme.

ANNEX 9. COUNTRY AT A GLANCE (INCLUDES COUNTRY MAP)

Iraq at a glance

November 15, 2009

Key Development Indicators ^a	Iraq	M. East & North Africa	Lower middle income	
(2008)				
Population, mid-year (millions) ¹	30.4	313	3,437	
Surface area (thousand sq. km)	438	8,778	35,510	
Population growth (%)	2.8	1.7	1.0	
Urban population (% of total population)	67	57	42	
GNI (Atlas method, US\$ billions) ²	88.3	876	6,485	
GNI per capita (Atlas method, US\$)	2,901	2,794	1,887	
GNI per capita (PPP, international \$)	..	7,413	4,544	
GDP growth (%)	9.5	5.8	9.7	
GDP per capita growth (%)	6.7	4.0	8.6	
(most recent estimate, 2000–2005)				
Poverty headcount ratio at \$1 a day (PPP, %)	..	5	..	
Poverty headcount ratio at \$2 a day (PPP, %)	..	19	..	
Life expectancy at birth (years)	61	70	69	
Infant mortality (per 1,000 live births)	82	34	41	
Child malnutrition (% of children under 5)	16	..	25	
Adult literacy, male (% of ages 15 and older)	84	83	93	
Adult literacy, female (% of ages 15 and older)	64	63	85	
Gross primary enrollment, male (% of age group)	108	108	112	
Gross primary enrollment, female (% of age group)	89	103	109	
Access to an improved water source (% of population)	61	89	88	
Access to improved sanitation facilities (% of population)	79	75	54	
Net Aid Flows				
<i>(US\$ millions)</i>				
ODA and official aid ³	63	101	6,178	2,384
<i>Top 3 donors (in 2005):</i>				
United States ⁴	336	0	5,957	2,138
Japan	-20	0
United Kingdom	54	14
Aid (% of GNI)	0.1	..	12.5	2.7
Aid per capita (US\$)	3	4	221	78
Long-Term Economic Trends				
Consumer prices (annual % change)	..	5.0	64.8	6.8
GDP implicit deflator (annual % change) ⁵	..	47.4	48.6	24.7
Exchange rate (annual average, local per US\$)	0.3	1,930.0	1,467.4	1,193.0
Terms of trade index (2000 = 100)
1980–90 1990–2000 2000–05				
<i>(average annual growth %)</i>				
Population, mid-year (millions)	18.5	25.1	27.9	30.4
GDP (US\$ millions)	48,657	25,763	49,529	91,497
<i>(% of GDP)</i>				
Agriculture	..	5.4	8.6	..
Industry	..	84.4	70.1	..
Manufacturing	..	0.9	1.7	..
Services	..	10.3	21.3	..
Household final consumption expenditure	37.4	41.9
General gov't final consumption expenditure	38.4	30.5
Gross capital formation	18.0	..
Exports of goods	57.4	59.5
Imports of goods	41.2	41.4
Gross national savings	27.1	22.9



	1980–90	1990–2000	2000–05
<i>(average annual growth %)</i>			
Population, mid-year (millions)	18.5	25.1	27.9
GDP (US\$ millions)	48,657	25,763	49,529
<i>(% of GDP)</i>			
Agriculture	..	5.4	8.6
Industry	..	84.4	70.1
Manufacturing	..	0.9	1.7
Services	..	10.3	21.3
Household final consumption expenditure	37.4
General gov't final consumption expenditure	38.4
Gross capital formation	18.0
Exports of goods	57.4
Imports of goods	41.2
Gross national savings	27.1

Note: Figures in italics are for years other than those specified. .. indicates data are not available.

(a) 2006 Indicators for Middle East and North Africa and Lower middle income countries 1. Staff estimates 2. GNI is calculated as sum of GDP and net income on annual exchange rate and differs from the atlas method. 3. ODA and official aid are total official receipts for the year 2007. 4. GDP deflator in U.S. dollar terms. 5. Gross savings are gross national savings derived from GNI minus gross domestic consumption plus net transfers.

Middle East and North Africa, Social and Economic Development Group (MNSD).

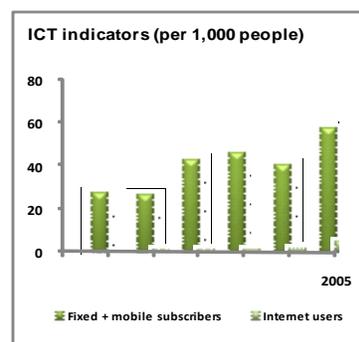
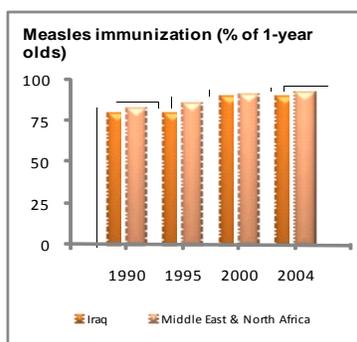
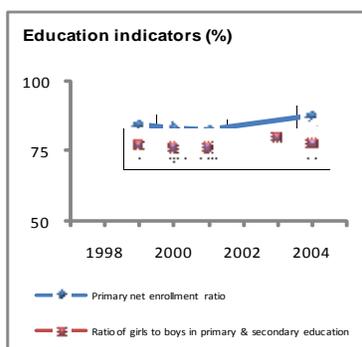
Millennium Development Goals

Iraq

With selected targets to achieve between 1990 and 2015

(estimate closest to date shown, +/- 2 years)

	Iraq			
	1990	1995	2000	2007
Goal 1: halve the rates for \$1 a day poverty and malnutrition				
Poverty headcount ratio at \$1 a day (PPP, % of population)	..	..	..	..
Poverty headcount ratio at national poverty line (% of population)	..	..	..	..
Share of income or consumption to the poorest quintile (%)	..	..	..	..
Prevalence of malnutrition (% of children under 5)	..	..	12.9	7.1
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	94	..	83	89
Primary completion rate (% of relevant age group)	58	59	53	75
Secondary school enrollment (gross, %)	44	..	36	45
Youth literacy rate (% of people ages 15-24)	..	..	85	..
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	78	..	76	78
Women employed in the nonagricultural sector (% of nonagricultural employment)	..	..	21	..
Proportion of seats held by women in national parliament (%) ¹	11	..	6	26
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	53	48	48	46
Infant mortality rate (per 1,000 live births)	42	38	38	37
Measles immunization (proportion of one-year olds immunized, %)	75	80	85	60
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	300
Births attended by skilled health staff (% of total)	54	..	72	89
	14	..	44	50
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	..	0.2
Contraceptive prevalence (% of women ages 15-49)	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	56	56	56	56
Tuberculosis cases detected under DOTS (%)	..	..	51	40
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	83	82	80	77
Access to improved sanitation facilities (% of population)	..	71	72	76
Forest area (% of total land area)	18	..	19	19
Nationally protected areas (% of total land area)	..	..	..	0.0
CO2 emissions (metric tons per capita)	2.6	3.4	2.9	3.0
GDP per unit of energy use (constant 2000 PPP \$ per kg of oil equivalent)	..	..	..	..
Goal 8: develop a global partnership for development				
Fixed line and mobile phone subscribers (per 1,000 people)	3.8	3.0	2.7	3.8
Internet users (per 1,000 people)	0.0	0.0	0.0	48.3
Personal computers (per 1,000 people)	0.0	..	0.0	0.2
Youth unemployment (% of total labor force ages 15-24)	..	..	0.8	..



Note: Figures in italics are for years other than those specified. .. indicates data are not available.

November 15, 2009

Middle East and North Africa, Social and Economic Development Group (MNSD).

IRAQ

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|---|---------------------------|-----|--------------------------|
| ○ | SELECTED CITIES AND TOWNS | — | MAIN ROADS |
| ⊙ | GOVERNORATE CAPITALS | — | RAILROADS |
| ⊕ | NATIONAL CAPITAL | — | GOVERNORATE BOUNDARIES |
| — | RIVERS | --- | INTERNATIONAL BOUNDARIES |



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