IOM
UN MIGRATION

LIVELIHOOD POLICY BRIEF NO.6

SMES' LOAN PREFERENCES AND BARRIERS: FINDINGS AMONG EDF-SUPPORTED BUSINESSES

AUGUST 2023

Funded by the European Union
USAID FROM THE AMERICAN PEOPLE
german cooperation DEUTSCHE ZUSAMMENARBEIT
Implemented by: KFW
Ministry for Foreign Affairs of Finland
KOICA Korea International Cooperation Agency

INTRODUCTION

Within community stability, income sources and livelihoods are crucial factors. As highlighted by the World Bank, small- and medium-sized enterprises (SMEs) make significant contributions to national income, accounting for up to 40 per cent of the gross domestic product (GDP) in emerging economies. In Iraq, SMEs form the majority of businesses and serve as essential income sources. The International Finance Corporation (IFC) reports over 1 million SMEs in Iraq, constituting more than two thirds of the private sector (IFC, 2016).

SMEs are vital in driving economic growth and job creation in Iraq. However, these businesses need help with their growth and potential economic contribution. This policy brief focuses on the challenges related to SMEs' access to formal financial sources and provides policy recommendations to address them. This brief presents data from three studies and empirical experiments conducted by the International Organization for Migration (IOM) in the past two years. These include a telephone survey conducted with a group of SMEs in July–August 2021; banking orientation session, and subsequent bank referral follow-ups since October 2021; and feedback on referred SMEs to the microfinance institute CHF VITAS Iraq. The brief analyses and comparing the data obtained from these various studies.

IOM's experience in assessing the SME market in Iraq, such as market assessments, value chain analysis, randomized control trials, follow-up calls, feedback mechanisms and observations shows that SMEs in Iraq face considerable obstacles. These challenges include lack of supportive regulatory environments, limited access to reliable information sources, security and political instability, scarcity of skilled workers, limited access to advanced technology and markets, and most notably restricted access to financial resources.

In Iraq, the flow of financial resources to micro, small- and medium-sized enterprises (MSMEs) needs to be improved due to breakdowns in the interaction between formal sources and potential customers. Borrowers need help with collateral requirements, interest rates and complex procedures. As found in COVID-19 study conducted by IOM, about 80 per cent of SME owners prefer to borrow money from friends and family than banks or formal sources. From the banks' perspective, serving MSMEs can be costly and present unattractive risk-return trade-offs. Establishing trust between business owners and banks is a time-consuming process that requires encouragement and vital contributions from organizations operating in the sector. Bridging the gap between SMEs and financial sources necessitates the involvement of a third party. To address this need, IOM has initiated efforts to enhance access to financial services for MSMEs across the country through various activities and interventions.

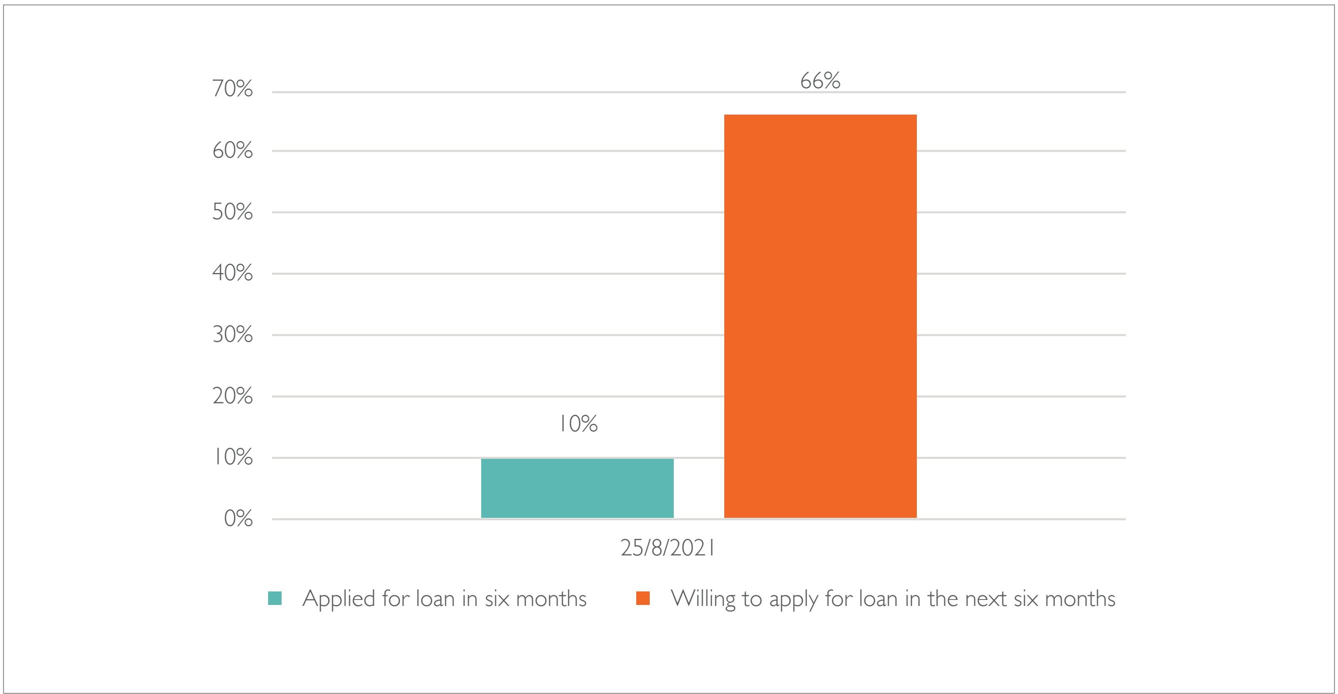
EXPLORING LOAN PREFERENCES AND BARRIERS

SURVEY RESULTS AMONG SME SUPPORTED BY THE ENTERPRISE DEVELOPMENT FUND

Between 15 July and 25 August 2021, IOM conducted a comprehensive telephone survey to gather updated insights and refine its understanding of various aspects related to SMEs supported by the Enterprise Development Fund (EDF).[1] The survey aimed to gather information on the following areas: (1) current business performance and growth outlook, (2) borrowing behaviour and factors affecting SMEs' access to commercial financing, (3) loan product features and preferences, (4) SMEs' ability to meet bank requirements for loan applications, (5) utilization of loan proceeds, and (6) interest in capacity-building activities to enhance qualification for commercial loans. The survey covered SMEs in Basra, Thiqar, Missan, Salah al-Din, Sulaymaniyah, Kirkuk, Erbil and Diyala. A total of 234 among 800 business owners who received support from the EDF were randomly selected and participated in the survey. The survey's instrument included binary (yes/no) questions, multiple-choice and open-ended questions.

Regarding borrowing behaviour, interest in future debts and factors deterring borrowing, the study shows that 90 per cent of participants did not apply for any credit within the past six months. However, as a response to the survey question "Are you interested in obtaining (additional) credit on commercial terms for your business operations (with IOM's help) within the next the six months or year?" A total of 65.8 per cent expressed a willingness to approach banks for financial support if facilitated by IOM (type of IOM help not indicated). Figure 1 illustrates the significant disparities between the actual experiences of business owners (fact) and their future interests (fiction) in obtaining a loan during the same timeframe.

Figure 1. Comparative analysis among telephone surveyed SMEs' actual experiences versus interest in borrowing[2]



Among those interested, 29 per cent preferred non-interest-bearing loans, such as Murabaha, due to religious beliefs prohibiting interest (Riba). Additionally, 31 per cent of participants reported using bank accounts for their businesses, while many preferred cash transactions, resulting in a lack of bank account maintenance.

95 out of the 154 respondents indicated their interest in loans within a range of 5,000 to 30,000 United States dollars (USD), with the largest requested loan size being USD 3,000,000.

Among the 109 respondents willing to consider interest-bearing loans, 67 per cent preferred an annual percentage rate (APR) of 5 per cent or less. Regarding the repayment period, 74 per cent of the respondents interested in loans indicated a need for a period of four years or longer.

For loan guarantees, 81per cent of the firms interested in accessing formal credit reported the ability to find a co-signatory, 45 per cent expressed the capability to guarantee a commercial loan with immovable property (real estate), and 38 per cent indicated the ability to provide both types of collateral. However, 13 per cent mentioned an inability to give guarantees through co-signatories or collateral pledges.

The reasons cited by participants interested in applying for credit included business premise and venue expansion (37%), purchasing machinery and business appliances (30%) and acquiring raw materials and goods (20%).The survey identified several constraints faced by SMEs in seeking loans. Out of the 154 interested businesses, 45 expressed religious reasons for not being interested in traditional commercial loans, opting instead for Murabaha products. Among the remaining 109 businesses willing to have interest-bearing loans, only 36 were willing to accept an APR above 5 per cent. Furthermore, 20 out of the 154 respondents indicated their inability to provide traditional required guarantees in the form of co-signatories or collateral pledges.

1 IOM's Enterprise Development Fund (EDF) is an innovative programme that supports livelihoods and job creation in small and medium enterprises (SMEs) through private sector revitalization and economic development in Iraq. The EDF provides financial capital to SMEs in primary, secondary and tertiary economic sectors with a high demand for labour. Concurrently, targeting key sectors and businesses with the greatest potential to create jobs, the EDF encourages rapid and large-scale job creation. The EDF helps businesses to expand and grow and create jobs. The EDF uses market data and data analysis for decision making. Through adaptations to different sectors or groups of individuals (such as women), the EDF continues to be flexible, adaptable and scalable. Comprehensive due diligence processes that are diversified across different incumbents reduce risk, ensure accountability, and increase efficiency and value-for-money. Operating since 2018, and till the time of this report around 2000 SMEs granted under this programme.

2 The graph presented illustrates data collected in a survey conducted on 25h August 2023. It compares the business owners' experiences in the six months leading up to the survey with their interest in obtaining additional credit in the subsequent six months.

EMPOWERING SMES THROUGH MICROFINANCE

EVALUATING CHF VITAS/ IRAQ[3] REFERRALS AND LOAN BEHAVIOUR

In late 2021, IOM signed a memorandum of understanding (MOU) with VITAS to mobilize financial resources to support IOM activities and refer EDF beneficiaries to VITAS for financial services. IOM interviewed SME owners between April and May 2022 to assess the interest in being referred to VITAS as an IOM partner financial institution. Out of 300 contacted business owners who had received grants from IOM under the EDF, 191 expressed their willingness to be referred. All the contacted business owners were in Baghdad and Basra governorates and all either completed the EDF milestones or were in a final stage of doing so. In June 2022, the list of 191 businesses was shared with VITAS for loan offerings, with 78 SMEs in Baghdad and 113 in Basra.

Table 1 provides the results of the VITAS contacts and follow-ups with the referred businesses to offer them extra financing spanning 10 months (between June 2022 and March 2023). The data include responses from 154 reachable businesses, while the remaining 37 businesses could not be reached by phone. The results are based on feedback from the partner financial institution.

Table 1. Referred businesses for microfinance.

Status	Baghdad	Basra	Total
Currently not interested or IOM client	45	25	70
Loan application in progress (Pending)/ or Business owner still preparing requirements	20	22	42
Interest to apply but still not found required guarantor	01	17	18
Required higher amount than offered by VITAS	00	15	15
Interested but did not apply due to a loan fee (interest)	03	02	05
Loan disbursed	02	02	04
Total	**71**	**83**	**154**

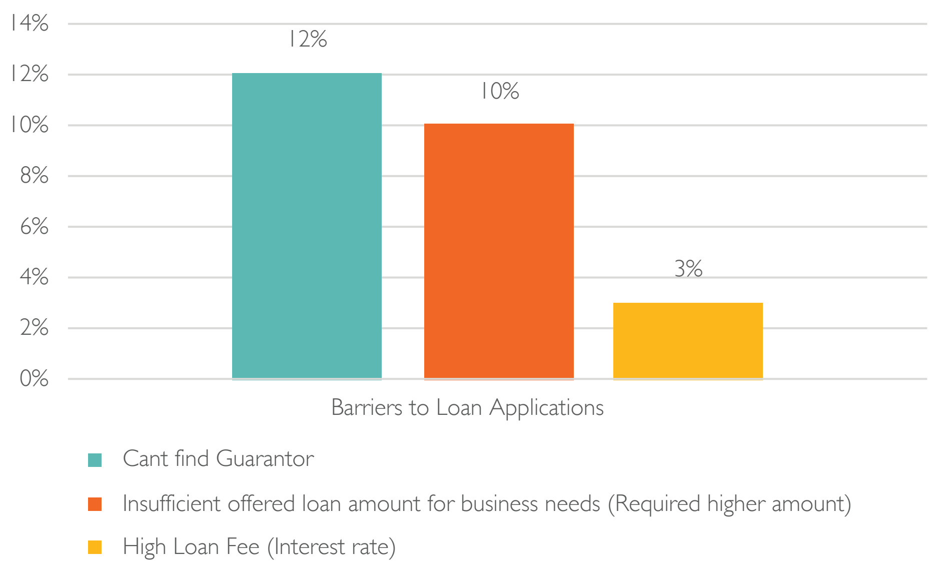
3 CHF VITAS IRAQ: a humanitarian non-profit microfinance institution operating since 2003 in Iraq under the approval of the General Secretariat of the Council of Ministers / NGO office. Non-profit organization that was established by Global Communalities (formerly CHF international).

Table 1 reveals 45 per cent of business owners are not interested in obtaining a loan due to a lack of interest or ongoing commitments with IOM grants. Twenty-seven per cent of the target group either applied or were in the process of applying for a loan, with 14 per cent in Basra and 13 per cent in Baghdad. Approximately 12 per cent of the companies did not apply for a loan due to their inability to find required guarantees, with most of these businesses located in Basra. Only 3 per cent of the businesses expressed interest but refrained from applying due to loan fees, with 2 per cent in Baghdad and 1 per cent in Basra.

In total, only 3 per cent of participants received additional credit from VITAS, with an equal distribution between the two locations (only four SME owners). Some business owners required between USD 20,000 and USD 40,000, exceeding the amounts offered by VITAS (10%); all of these businesses were located in Basra.

Furthermore, Figure 2 highlights the barriers that prevented the interested businesses from applying for a loan.

Figure 2. Barriers to loan applications among VITAS referrals: challenges faced by interested businesses.



ROADBLOCKS TO BANKING

UNDERSTANDING THE CHALLENGES FACED BY BUSINESS OWNERS IN ACCESSING BANKING SERVICES AND BORROWING

In August and September 2021, IOM conducted a comprehensive survey targeting potential finance institutes, explicitly focusing on private banks. The study aimed to gather information about their available products, customer relations strategies, promotion methodologies, decision-making procedures and loan application processes. Additionally, the survey assessed the banks' interest in collaborating with IOM to provide banking sessions and services to EDF-targeted businesses that have benefited from IOM grants.

Out of the 16 potential finance institutes approached, 13 were engaged, but only three responded to the detailed questionnaire; those banks were approached randomly in different governorates. Since then, numerous meetings and communications have been held with different banks, including NBI, Kurdistan, Ashur and IDB.

Based on this exercise, from October 2021 until April 2023, IOM organized nine banking orientation sessions in collaboration with four banks mentioned above across eight governorates throughout the country. In total, 174 business owners attended these sessions. Five hundred EDF-granted businesses who completed all milestones or were in the final stages were surveyed over phone calls to check their interest, then interested ones were invited over phone calls to the banking orientation session for each location.

Figure 3. Location of surveys and activities.

The participation of business owners was significantly lower than their initial confirmations during the pre-bank session phone calls. Approximately half of the business owners who confirmed their attendance over the phone failed to attend the sessions. Each business owner who participated in the banking orientation received follow-up calls to gain insights into their interests in banking services, loan applications and challenges. In the first follow-up, 152 out of 174 businesses were reachable (87%), and subsequent follow-ups were conducted only with those who had shown interest in banking services in their previous follow-ups. However, in all follow-ups, some businesses remained either unreachable or unresponsive (13% and 50% in the second and third follow-ups respectively). Table 2 illustrates the number of interested companies referred to the bank in each follow-up:

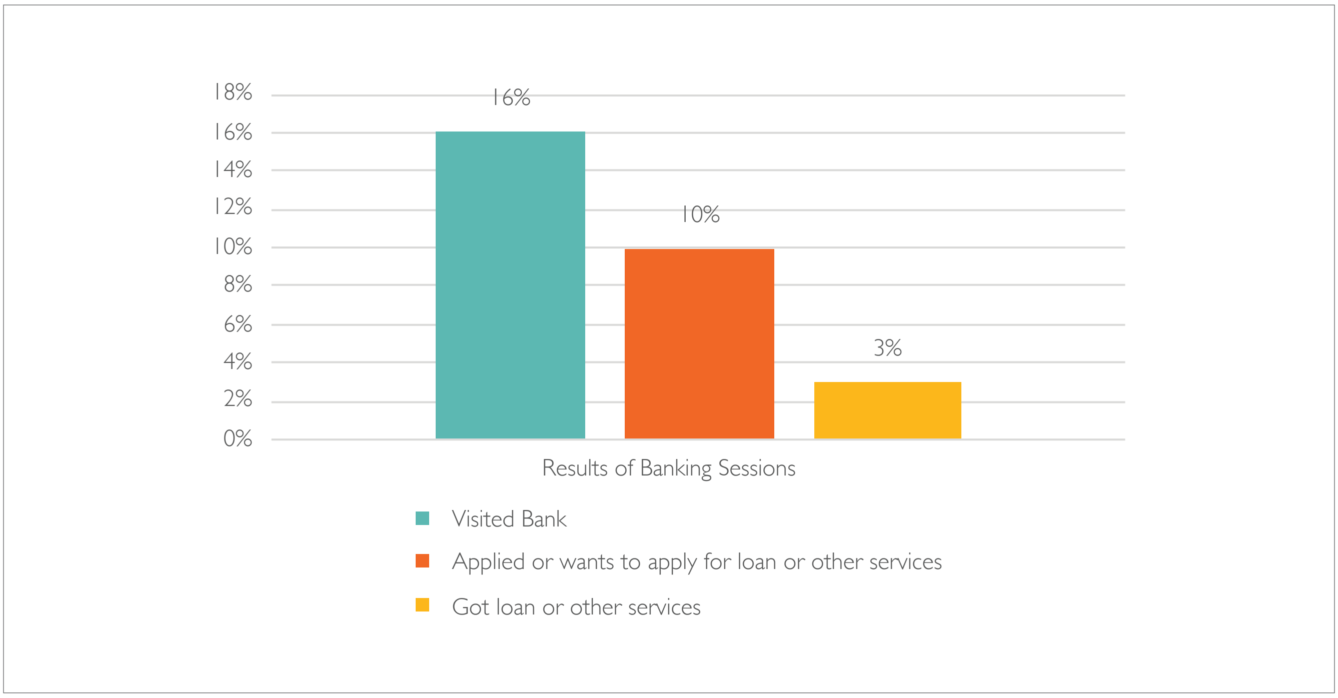
Table 2: Attendance to banking orientation sessions.

Follow-up Calls	First	Second	Third
Respondent	152	77	31
Interested to be referred (Still interest for Banking services)	89	62	26

Only 26 out of 152 respondents (17%) expressed interest in approaching banks as a result of three follow-up calls. This finding aligns with the behavioural patterns observed among business owners regarding borrowing and banking services.

Among the businesses that participated in the sessions and underwent follow-ups, 27 firms (18%) visited banks, 13 (9%) applied for or expressed an intention to apply for loans, banks disbursed three loans (2%) and three businesses managed to open bank accounts (2%). Figure 4 provides a visual representation of these results.

Figure 4. Outcomes for participants in banking sessions



The survey also shed light on business owners' barriers and challenges in accessing banking services. Of the businesses contacted after the sessions, 63 were not interested in being referred to banks. The primary reasons for their lack of interest were high-interest rates and religious concerns on interest rate as Haram (Riba) as indicated by 60 per cent of them. Ten per cent of those 63 firms were reluctant to approach banks due to a lack of mortgages or difficulty with banking procedures.

Those who did show interest encountered similar barriers to those who were uninterested. However, they were mainly frustrated by the banks' requirements and attitudes. Specifically, 27 businesses faced issues with procedures and required guarantees, while 20 experienced difficulties with banks' customer services, appearance and behaviours. Some feedback provided in Table 3 highlighted these concerns. Additionally, 11 businesses expressed dissatisfaction with the interest rates offered by the banks or religious concerns regarding interest as Haram (Riba).

Table 3: Examples of SMEs' frustrations with banks

The bank did not provide loans in the locations they claimed they would.	Banks did not reach out to businesses even after promising to do so.	Language barriers prevented banks from providing services in the business owners' language.	Banks did not accept certain types of guarantees, such as salary or mortgages, in specific locations.	Banks' procedures and customer services were deemed unhelpful.

The feedback presented some of the reasons why businesses have reluctance when approaching financial service providers, particularly banks, for securing financial resources to support their expansions. The two figures below illustrate the main barriers and challenges faced by the respondents in obtaining banking services.

Figure 5 A: Businesses' barriers and challenges for obtaining banking services among businesses not interested in being referred

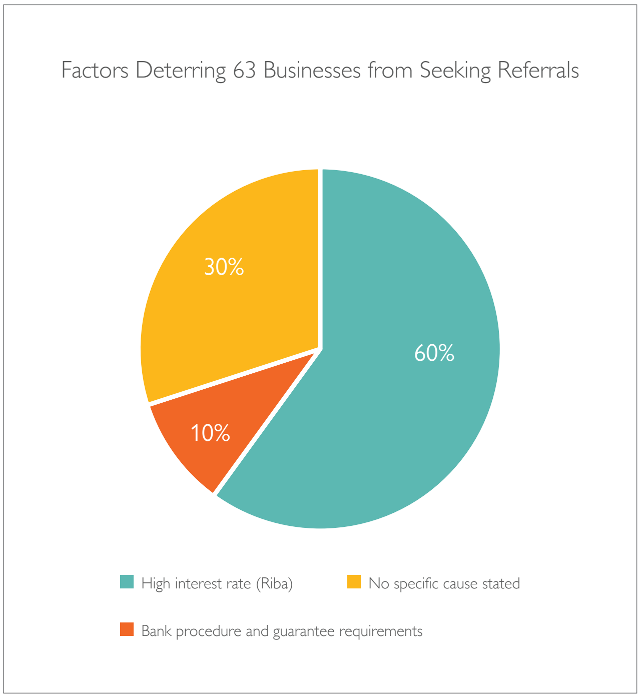
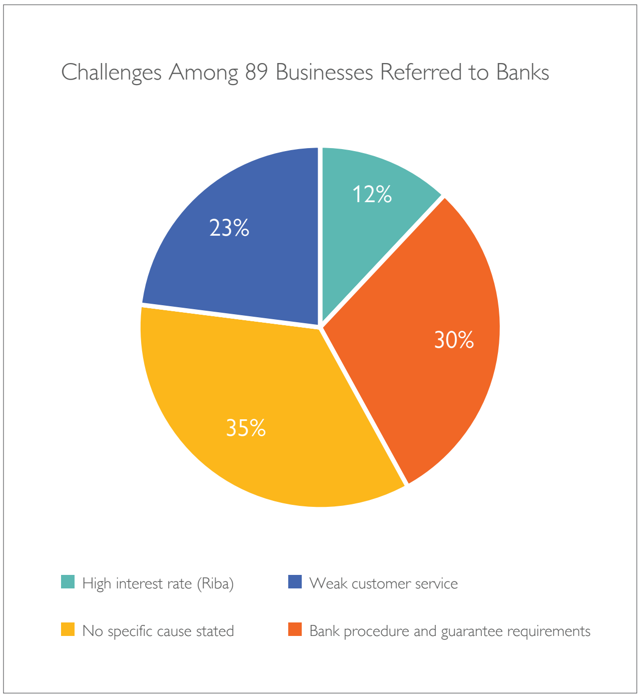


Figure 5B: Businesses' barriers and challenges for obtaining banking services. Interested and referred firms.



CONCLUSION

This document presents three data collections: survey responses by SMEs, their experiences with microfinance institutions, and their experiences with banks. The policy brief compared firms' experiences and expectations with the financial institutions.

The survey indicated that 10 per cent of participants approached banks for loans, while 68 per cent expressed interest. However, after financial capacity-building sessions, 18 per cent of SMEs showed interest in banking services and 11 per cent applied for or attempted to apply for loans, with only 2 per cent of the sessions' participants being successful in getting the loan. This percentage of applicants is significantly lower than SMEs approaching microfinance institutions. As indicated above, 30 per cent of businesses engaged with VITAS either applied for or prepared for loan applications, and 3 per cent of businesses that were reached by VITAS received loans. It is worth noting that the time it took for IOM-referred businesses to hear back from banks was significantly longer compared to that for IOM-referred businesses to hear back from microfinance institutions.

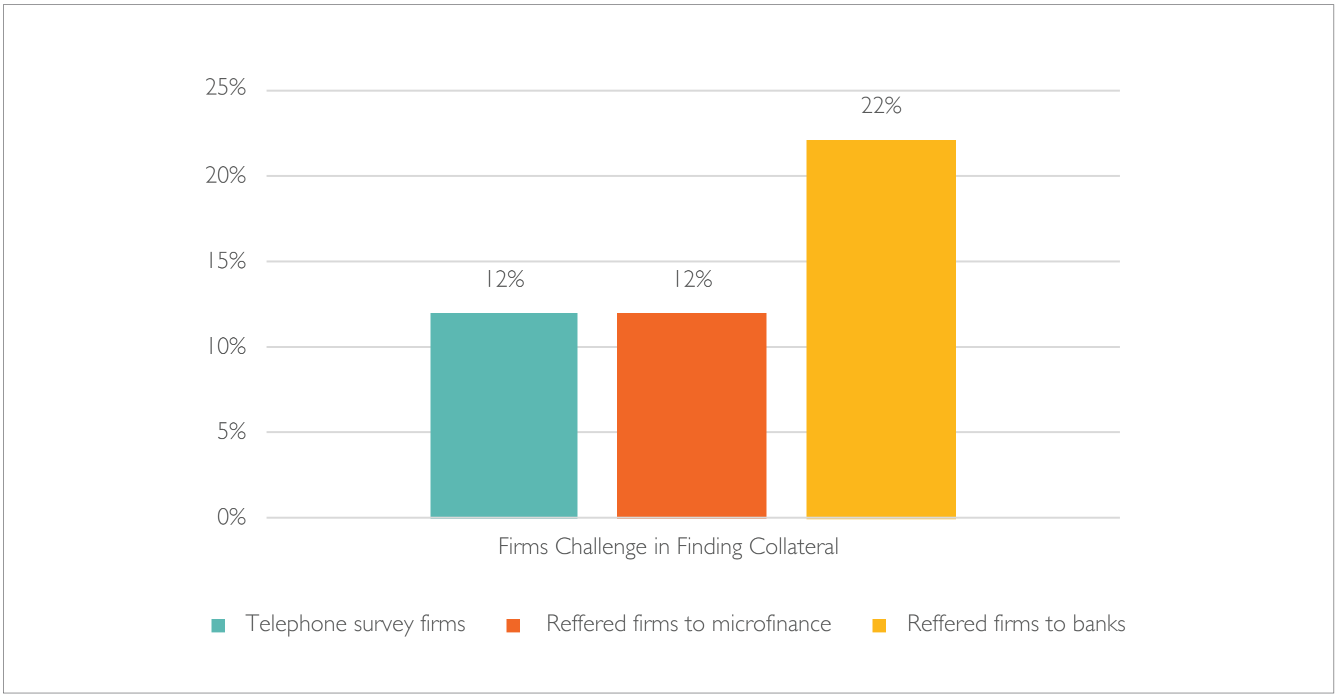
SMEs need more collateral and credit history to access financial resources. Banks often require collateral as security against loans, and SMEs in Iraq may struggle to provide such collateral due to losses incurred during the conflict. Similarly, limited or no credit history makes it difficult for SMEs to demonstrate their creditworthiness and access loans from financial institutions, especially banks.

To address these issues, IOM has provided tailored solutions to strengthen business management capabilities using the International Labour Organization (ILO) methodology. IOM has provided marketing training to help SMEs expand their businesses and prepare loan application plans. Moreover, IOM offers bookkeeping sessions to help SMEs establish better financial records. These capacity-building initiatives can increase banks' trust in SMEs and foster financial inclusion and investment readiness.

Furthermore, addressing collateral issues may require convincing Iraqi policymakers to revise lending policies and consider alternative forms of collateral beyond traditional options such as mortgages or government employee guarantees. Business assets and third-party guarantors could serve as additional or alternative forms of collateral in Iraq's future. The Iraqi Company for Bank Guaranty has been approached by IOM to act as supportive collateral for SMEs seeking additional credit. However, the company's capacity and infrastructure need further development to serve as an alternative or support for existing collateral effectively. IOM has conducted assessments and allocated funds for this purpose since July 2022.

To understand businesses difficulties in finding collateral, the data obtained from the three studies described in this document were compared The telephone survey findings indicated that SMEs were more confident about finding collateral for credit. When asked, 81 per cent of interested businesses claimed they could find a co-signatory, 45 per cent said their ability to guarantee a commercial loan with immovable property (real estate) and 38 per cent stated they could provide both types of collateral. Only 12 per cent mentioned difficulties providing guarantees through a co-signatory or collateral pledge. Microfinance institutions-referred firms showed the same results as telephone surveyed firms, with 12 per cent of them expressing difficulties finding collateral. Actual refered businesses to banks meanwhilefound that 22 per cent of the referals faced difficulties in finding collateral, illustrating a potential disconnect between percieved and actual collateral requirements and the ability to meet them. For example. one firm referred by IOM was told that the bank could not accept the real estate property as it was from a distrtrict outside of the location of the bank's branch. One business owner applied for 100 million Iraqi dinars (IQD) and his application was almost completed, but he asked the bank to stop the procedure because he found that for this amount of loan, in addition to the bank's interest charge, he would have to pay an additional 3 per cent (IQD 3 million) of the loan amount as a fee to the government to release the asset from the collateral registry after the completion of the loan repayment. Three participants who showed interest also claimed that the banks were not providing reasonable application processes (two of them who wanted to take IQD 15 million, and one was interested in borrowing IQD 30 million), and mentioned that the bank asked for real-estate mortgages, while the loan amount was small in comparison. One mentioned that the bank asked for a government employee as a guarantee who has a salary card (Qi card) in Ashur Bank (the bank offering the loan) only. These examples illustrate the difference between advertised and perceived collateral requirements up-front, and the actual situation in accessing loans using collaterals according to local banking practices. The above data are presented in Figure 6.

Figure 6. Percentage of businesses facing collateral challenges for obtaining loans.



In Iraq, a post-conflict country, financial institutions often apply higher interest rates to SMEs to mitigate perceived lending risks. However, business owners' religious beliefs significantly influence their behaviour, particularly among those with less immediate needs. For example, business owners who do not require immediate financing show more hesitation about religious beliefs prohibiting interest (Riba).

According to the telephone survey, 29 per cent of the businesses were unwilling to apply for commercial loans due to Riba. Even after participating in banking sessions, this percentage remains considerably high, with 60 per cent of those not interested in being referred to banks attributing their hesitation to interest rates, particularly in relation tothose religious beliefs.

However, among those interested in being referred to banks or microfinance institutions, the percentage of concerns about interest rates is relatively low. Only 12 per cent of bank referrals and 3 per cent of microfinance referrals expressed concern regarding interest rates. The hesitation of business owners is primarily related to their perceptions of whether the loans are considered "Haram" (prohibited) or not, rather than the actual interest rates themselves.

Interest rates offered through the CBI initiative are significantly low, with rates not exceeding 3.5 per cent. In contrast, microfinance interest rates in Iraq are around 10 per cent or higher, although in the case of VITAS, the loans are considered Islamic-compliant as they are taken up-front as an administrative fee. Business owners appear to have fewer issues with microfinance interest rates, indicating that personal thoughts and attitudes towards interest rates, especially religious acceptability, play a significant role.

Banks in Iraq offer two types of loans. The first type is loans facilitated by banks using the funds allocated by the CBI within the one trillion-dinar initiative. These loans have lower interest rates since they are supported by the CBI. The second type of loans, which have higher interest rates similar to those offered by microfinance institutions, are provided by banks using their own capital. Unlike the CBI-supported loans, these loans are not part of the initiative and thus carry higher interest rates.

POLICY RECOMMENDATIONS

In mid-January 2023, the CBI issued new regulations to transact only in local currency inside Iraq companies. CBI also issued a process to repatriate foreign currency against approved invoices and/or a contractual obligation to face enormous instability in the value of the Iraqi dinar versus the United States dollar after Iraq became part of the international electronic banking system in November 2022. These new regulations caused uncertainty in the market, and Iraq experienced a shortage of dollars in the open market. The essence of these regulations is to buy foreign currency from CBI to repatriate and enforce the official rate for currency conversion through licensed currency exchanges. These licensed exchanges can convert foreign currency into Iraqi dinars only at the rate CBI prescribes. Before the issuance of these regulations, the dollar was traded at 1,450–1,470 dinars to one dollar. The new official rate prescribed by CBI in January 2023 was 1,320 dinars to one dollar.

In addition to Iraq's security and political instability, the devaluation of the Iraqi dinar against foreign currencies significantly impacts the Iraqi market. As a result, in recent years the Government of Iraq has been making efforts to address these challenges by implementing policy changes that have a notable impact on financial service providers, but the changes have not come without challenges. Iraqi banks will need time to adapt to the new procedures and the electronic system and the economy will probably need years to move from the dominance of informality and cash.

In the long term, addressing business owners' personal beliefs and attitudes may also require sustained efforts. Information provision could be one of the solutions. Policymakers can in the meantime focus on developing financial products that align with the specific needs of businesses in the region. Products such as Murabaha, financing purchases or properties, or other similar alternatives, could help address the restrictions imposed by religious considerations and better serve the needs of business owners.

Financial service providers in Iraq often need help with weak customer service, which leads to difficulties for customers in navigating complex processes, obtaining accurate information and receiving timely assistance. This lack of adequate customer support hampers the overall customer experience and undermines trust and satisfaction levels, discouraging individuals from fully engaging with financial institutions.

Furthermore, the physical presence and accessibility of financial service providers in Iraq can be lacking, especially in areas outside of main cities. The geographical disparity limits individuals' access to banking services, forcing them to travel long distances or rely on informal financial channels. This limited presence perpetuates financial exclusion and hinders the development of inclusive and equitable financial systems.

The evidence gathered from the telephone survey and feedback obtained during banking sessions follow-ups highlights the challenges faced by businesses when dealing with banks, indicating weak banking infrastructure in Iraq. Within the scope of this research, businesses' experience with interacting with microfinance institutions was not collected and analysed; this aspect could be further explored in future research. Addressing these challenges requires strengthening institutional support, enhancing financial infrastructure and prioritizing customer-centric approaches. By promoting regulatory frameworks, fostering collaboration among stakeholders and investing in technology-driven solutions, Iraq can foster a more inclusive and efficient financial ecosystem that meets the diverse needs of its population.

Initiatives to expand the physical presence of financial service providers and improve customer service standards will contribute to a more accessible and satisfactory experience for individuals and businesses. Additionally, since November 2022, Iraq has become part of the international electronic banking system, transitioning from its previous paper-based system. This change is expected to bring more scrutiny to international transfers and may shift the focus of current banks toward improving customer services. The transition could lead to changes in the competition among financial credit providers, potentially attracting new players to the market and causing some existing service providers to lose market shares or even exit the competition.

REFERENCES

Ahmed Tabaqchali (Interview). "Iraq Economic Review the Dinar & Al-Sudani's Agenda" What's Happening with the Dinar? Available from: *https://auis.edu.krd/iris.* (February 2023)

Zimmermann, F. Misperceived social norms: Women working outside the home in Saudi Arabia. American economic review, 2020, 110 (10), 2997–3029. Available from: *www.aeaweb.org/articles?id=10.1257/aer.20180975.*

The Wold Bank. Small and Medium Enterprises (SMEs) Finance, Improving SMEs' access to finance and finding innovative solutions to unlock sources of capital. *World Bank SME Finance: Development news, research, data | World Bank.*

International Finance Corporation – IFC, IFC Supports Small and Medium Enterprises in Iraq, *https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=16612,* (May 24, 2016).

IOM IRAQ

iraq.iom.int

iomiraq@iom.int

UNAMI Compound (Diwan 2),
International Zone,
Baghdad/Iraq

@IOMIraq

Funded by the European Union

USAID FROM THE AMERICAN PEOPLE

german cooperation DEUTSCHE ZUSAMMENARBEIT

Implemented by: KFW

Ministry for Foreign Affairs of Finland

KOICA Korea International Cooperation Agency