

RECONSTRUCTING IRAQ: AN ANALYSIS OF, AND PROPOSED SOLUTIONS TO, THE FINANCING CHALLENGES FACING IRAQI SMALL AND MID-SIZE BUSINESSES

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In the course of recent work in Baghdad, I have gained some personal perspectives regarding what it takes to do reconstruction business in Iraq under the rules and realities of the U.S.-led administration of Iraq. Most particularly, I have witnessed the dilemmas, discouragements and challenges encountered by struggling small and mid-size Iraqi businesses that been left either “capital depleted” or “capital flat.” This lack of capital arises in largest part because financing structures and facilities for these privately-owned entities disappeared with the collapse of the former regime, and no initiative has yet been taken to remedy this unfortunate situation. In my view, very serious policy and practical implications flow directly from this difficult, but fixable, set of facts.

My suggestions are borne of substantial involvement with the post-Cold War reconstitution of the economies of Central and Eastern European states as well as the Republics of the former Soviet Union, and the reconstruction of Bosnia, the Former Republic of Yugoslavia, Afghanistan and, now, Iraq. In Iraq, I have been involved in critical assessment and analysis of the legal system and business economy of Iraq since 1997. Most recently, I have spent the better part of the past six months on the ground “in country,” speaking with approximately 300 senior Iraqi business, banking, legal, professional and political leaders about what is needed now to make the reconstruction a success, and then critically examining what each had to say, from practical, economic, legal and political perspectives.

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CAPITAL CONCENTRATION IN LARGE FAMILY-RUN BUSINESSES

Under present circumstances in Iraq, small and mid-size Iraqi businesses are forced to turn to practically the only sources that are ready, willing and able to provide financing of subcontracts awarded by the American firms that hold the U.S. Government and Coalition Provisional Authority (CPA) prime contracts: the capital-sufficient business entities owned and operated by most of the twelve prominent and influential Iraqi families. These are the twelve families who have been dominant in the Iraqi private sector dating back to the Ottoman rule.

The leaders of these family-owned and operated entities are business-savvy and know how to extend an advantage, and they do just that. These entities have been well capitalized, and are well financed—perhaps even more so now that the former regime has passed. The family leaders of such large businesses protected their assets over the last thirty-five years by transferring large sums of money out of Iraq to global financial centers, such as Geneva, to protect against the ravages of the former regime. And they know well the Iraqi private business sector and understand how to maneuver in the Iraqi marketplace to gain advantage for the short-, medium- and long-term. Consequently, these large entities “snap up” opportunities when and where circumstances allow. What does that mean in the realm of reconstruction contracting by undercapitalized small/mid-size Iraqi firms? Simply this: with no place else to turn for financing, these fledgling Iraqi businesses must turn to the family-dominated entities for financing, on onerous terms that we in the West would considered to be predatory.

The typical deal goes something like this:

1. A medium or small Iraqi firm that historically possesses the qualifications to do certain types of work—for example, providing concrete or other building materials, or doing mechanical/electrical work on reconstruction or new construction—becomes qualified to bid for an Army Corps of Engineers or U.S.A.I.D. subcontract through Halliburton/Kellogg, Brown & Root (KBR) or Bechtel, respectively. Of course, U.S. Government money will pay for this subcontracted work.

2. In the aftermath of the war, these technically-capable small/midsize Iraqi companies cannot obtain contract financing from any financial institution—whether Western, Arab or Iraqi public or private sector (*e.g.*, either of the state-owned banks or the seventeen or so Iraqi private banks)—simply because the risks of providing contract financing in the current environment

are deemed to be too high to place at risk the capital and shareholder investment in such banks/financial institutions.

3. The small/mid-size company then goes to the only available financing market—that is, the capital-sufficient entities owned and controlled by one of the twelve families, and receives these non-negotiable terms:

For a \$1 million contract performed over a period of three-to-six months, the borrowing business must increase the bid to provide the lending family entity with a return equal to one-half of the maximum profit that can be obtained on the project—perhaps a net of ten percent to the lending family for putting well less than \$1 million at risk for a few months. This becomes the baseline bid price to Bechtel, KBR and others for most bids by small/mid-size Iraqi companies, since most (being in the same undercapitalized position) must turn to similar financing sources and receive equivalent terms. This has the effect of substantially driving up the contract price paid for out of U.S. funds or the Iraqi funds administered by the U.S. through the Development Fund for Iraq (for CPA subcontracts).

The family entity also insists on obtaining a significant ownership interest—and in some instances controlling management of—those Iraqi businesses that the family entity finances. This typically includes the right to receive a share of earnings on all projects in the future, in proportion to the family entity's newly-acquired ownership interest.

Why do the Iraqi family-owned enterprises do this? For two reasons. First, the lending family entity uses this position in the financed company to protect its loan/investment. Second, and perhaps more importantly, having an equity interest in the financed business allows the large family entity to capture additional shares of the Iraqi reconstruction market—and cash flow—by virtue of the control that can be exercised over small/mid-size Iraqi firms that have already succeeded in being qualified by the CPA, Bechtel, KBR and the like to bid on Iraqi reconstruction subcontract tenders funded by U.S. and Iraqi dollars.

4. The small/mid-size Iraqi company then successfully performs the contract.

5. The small/mid-size Iraqi company then delivers one-half of the inflated profits to the financing family entity.

6. The small/mid-size Iraqi company, under the oversight and perhaps control of the large family entity, bids other contracts, and the process repeats itself over and over, and dollars flow into the coffers of both the family-owned entities, as well as lesser earnings to the small/mid-size Iraqi businesses. All of this goes on “under the surface” in private transactions between large

family-owned enterprises and those smaller Iraqi business entities that need this help because no alternative—such as the formation and operation of regulated finance companies, equivalent to what exists here in the United States and elsewhere in the world—exists for these legitimate but under-capitalized independent businesses.

The overall effect of this circumstance is deleterious to creating short- and long-term economic, political and social stability in the Iraqi private business sector. First, as in America, restoring the health of small/mid-size Iraqi businesses is and will continue to be the single most powerful engine for employing the forty to fifty percent of Iraqis who want jobs but simply cannot find them. The vitality of the Iraqi private business sector drove the prosperity in Iraq during the economic boom of the mid- to late-1980s—before the Iran-Iraq war took its toll on the Iraqi economy, before Saddam Hussein's invasion of Kuwait and the ensuing the Gulf War, and before the UN sanctions regime. This private sector development is not occurring as it could. The small/mid-size Iraqi businesses who do not cave in to the financing demands of the large family enterprises simply do not get capitalized, and, therefore, cannot effectively compete for the reconstruction contracts. Companies that cannot compete for these contracts cannot put employees back to work, much less expand their workforces by hiring Iraqis that desperately want to go back to work.

Additionally, with fewer Iraqi qualified companies independently operating because of unsolved capitalization problems, legitimate competition for U.S. Government- and CPA-funded subcontracts is not what it could be, and contract prices are far above what they should be. One example is the cement industry in Iraq. In July and August of this year, the price of cement soared to almost \$100 per ton in Iraq—more than twice what it was on the world market. This was because Iraqi cement companies had not been capitalized to re-start operations, and therefore were not producing for or operating in the domestic market. Of course, at that price, cement from outside Iraq flooded the market. The price of cement in Iraq dropped to about \$60/ton—still significantly above the world market price. And, most of the “capital flat” Iraqi cement companies remained without the capital to resume operations, simply because there was no financial institution source for legitimate borrowing to recapitalize these businesses. (Excepting, of course, those private sector cement companies that cut financing deals with the family-owned enterprises, along the model I have just discussed.)

Finally, private sector capital is being unnecessarily concentrated in Iraq in the hands of the well-capitalized family-owned entities. If history is a guide,

the power that comes with such capital concentration likely will be used to further the market position and interests of a privileged few, to the detriment of the many Iraqi entrepreneurs who are willing, but presently unable, to restart and expand existing businesses as well as start new businesses.

THE NEED FOR PRIVATE SECTOR FINANCIAL INSTITUTIONS DEDICATED TO CONTRACT FINANCING

Each of these deleterious effects can be avoided by the United States and the U.S.-led CPA establishing the predicate conditions for the emergence in Iraq of Iraqi private sector financial institutions dedicated to providing contract financing to small/mid-size Iraqi businesses on non-onerous terms equivalent to those that are seen elsewhere in the developed world. Based on discussions with officials at the Central Bank of Iraq and extensive discussions with various senior executives of private banks in Iraq and financial institutions in the United States, Europe and the Arab world, I feel that it is possible now to establish these Iraqi financial institutions, so long as the following prerequisites are created:

First, under the current circumstances in Iraq, financial institutions are most hesitant to put their own capital at risk. Even so, however, senior executives of a fair number of financial institutions—most particularly regulated Iraqi private banks and Arab banks—are keen on establishing lending facilities for contract financing if the “capital risk” problem can be solved. I estimate that it can be solved through the creation of a lending fund of approximately \$500 million from Iraqi seized assets that would be available to be drawn upon for lending by registered Iraqi financial institutions dedicated to providing contract financing in accordance with approved lending and risk-mitigation practices. A fund of this size would provide sufficient “revolver” contract financing at a level that would accommodate all Iraqi companies that are qualified to bid for subcontracts under the forthcoming USAID \$1.5 billion Phase II Infrastructure contract (the follow-on to the Bechtel infrastructure contract) and the current and forthcoming follow-on U.S. Army Corps of Engineers Operation Restore Iraqi Oil (Operation RIO) contracts. Ideally, this fund would be available to all financial institutions providing contract financing that meet the conditions for regulation—much like Federal Reserve funds are made available for loan at the Fed Rate to banks in the United States.

Second, Iraqi private banks may need to acquire or be provided with the practical expertise to set up and conduct such contract financing lending operations. Such expertise is present throughout the developed world, but

infusing such expertise into lending institutions in Iraq may require a technical assistance initiative. This can be accomplished in a straightforward manner through CPA contracts to provide such expert technical assistance to those financial institutions in Iraq that show themselves to be qualified and dedicated to establishing contract financing operations. The CPA did something quite similar in establishing the legal prerequisites—and then putting out the tender—to establish the Iraqi Trade Bank to provide needed letters of credit to pay for goods coming into Iraq under reconstruction contracts. This certainly strongly suggests that such an initiative falls within the realm of the doable here as well—as long as there is the will to do so. In conclusion, I believe that pursuing such initiatives can result in a more cost-effective reconstruction of Iraq as well as a further restoration of stability in Iraq through the preservation and vibrant expansion of the independent private business sector.