



MEETING THE DEMAND FOR MICROFINANCE IN THE WEST BANK AND GAZA

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I. OVERVIEW

This report stems from a request made of CGAP by James Wolfensohn, the Quartet's Special Envoy for the Gaza Disengagement, and Nigel Roberts, World Bank Country Director for the West Bank and Gaza. Specifically, CGAP was asked to assess the Palestinian microfinance sector, identify the obstacles to the development of microfinance and make recommendations for reform measures needed to increase access to financial services in the West Bank and Gaza for poor people and microenterprises. The backdrop for the request is the conviction—voiced by the World Bank and others—that a rapid revival of the Palestinian economy is essential to the success of the peace process and a vital component of such revival will involve improving the situation of the Palestinian poor.

The report is written with the expectation that there will be an independent Palestinian state with borders with its neighbors (Israel, Jordan, Egypt), open for trade and with travel between the West Bank and Gaza. Once the issue of closure is resolved, it will be essential—if the Palestinian economy is to grow and the Palestinians are to prosper—for there to be a well-functioning financial system that serves all segments of the population.

The report outlines the findings of two missions as well as preparatory and follow-up research conducted by the authors with the assistance of Palestinian legal counsel.² The two missions were a preparatory mission undertaken by Mohammed Khaled in July 2005 before the disengagement process and a policy/diagnostic mission undertaken by Mr. Khaled, Kate Lauer, and Xavier Reille in September 2005 during the final days of the disengagement.

¹ Xavier Reille is the director of the MENA initiative at CGAP. Mohammed Khaled is a microfinance expert. Kate Lauer is a lawyer and an independent consultant. The authors received substantial editorial input from Timothy Lyman, CGAP's senior policy advisor, and their research was supported by the Palestinian law firm of A. F. & R. Shehadeh as well as the Palestinian lawyer Samer Fares. During the preparatory mission and policy/diagnostic mission, the authors consulted with Palestinian government officials, bankers, microfinance practitioners and other financial system professionals, and donor representatives (all of whom are listed on Appendix A). The authors are grateful to these persons for the information and insights they supplied. To the best of the authors' knowledge, the contents of this report (unless otherwise noted) are current as of October 2005.

² Laws and secondary material reviewed by the authors are listed on Appendices B and C, respectively.

Part II of this report discusses the Palestinian economy. Part III describes the Palestinian financial system. Part IV reviews the current state of the microfinance sector as well as the donor projects in the area of financial services for the poor. Part V describes the current legal and regulatory environment for microfinance activities and identifies certain obstacles. Part VI concludes the report with CGAP's recommendations to policymakers and donors.

II. THE PALESTINIAN ECONOMY

Current Situation. The basic facts of the Palestinian economy today are bleak. Average income has declined by more than 30% since the beginning of the Al Aqsa Intifada in September 2000. Almost 50% of Palestinians in the West Bank and Gaza (1.7 million of 3.6 million) live below the poverty line (i.e., US\$2/day), and 600,000 live below subsistence level. The unemployment rate (according to the "relaxed" definition, which includes those unemployed, whether or not currently seeking a job) exceeds 30%.³ And there has been an increased "informalization" of the Palestinian economy.⁴ A 2003 study estimated that there were approximately 110,000 informal businesses, an increase of 50,000 since the beginning of the Intifada.⁵ The situation is widely recognized to be due to the occupation and Israel's closure policies. However, a major reform of the closure policies, together with other changes to the Palestinian governance and the legal and regulatory framework that support the rule of law and the development of the private sector, will create a more hopeful situation for the Palestinian economy (assuming the necessary financial assistance from the international community).

Donor Aid. Donor funding for the West Bank and Gaza shifted from development to emergency assistance since the beginning of the Al Aqsa Intifada. In 2000, the ratio of development assistance to emergency assistance was 7:1; in 2002, the ratio was 1:5. It is anticipated that future donor aid will be primarily directed toward development projects and away from humanitarian assistance. The December 2004 World Bank paper "Stagnation or Revival? Israeli Disengagement and Palestinian Economic Prospects" outlines four scenarios for donor contributions from 2005–2008, ranging from US\$3.4 billion to US\$5.3 billion. (Donor assistance to the West Bank and Gaza in 2004 was approximately US\$900 million.) However, as noted in the paper, donor assistance can achieve little in the absence of a positive policy environment and improved political conditions.

Medium Term Development Plan. The Ministry of Planning (MoP) has primary responsibility for formulating the national development plans and for monitoring donor assistance to the Palestinians. In December 2004, the MoP presented its Medium Term Development Plan 2005–2007 (MTDP), which is to be the "primary guide for identification of priority areas for the donor community." The MTDP has two stated overarching goals: (1) "to reduce poverty in a sustain-

³ Since 2000, the number of Palestinian workers employed in Israel has declined significantly, which contributes to the rise in unemployment as well as lower average income. In 1999, approximately 135,000 Palestinian laborers were employed in Israel. The number decreased to 50,000 in 2004 and is somewhere in that range today. It is currently Israel's policy, as specifically articulated in the disengagement papers, to stop issuing work permits to Palestinians by 2008.

⁴ "Informal" businesses are not registered. Typically, an informal business is operated out of a person's home or on the street and there are either no employees or perhaps one employee.

⁵ According to this study, the informal sector employed 188,000 people, generating 50% of the income for 100,000 households.

able way, by providing a framework to shift PNA and donor assistance from emergency relief to job creation, recovery and economic development” and (2) “to improve the effectiveness of PNA governance by building institutional capacity and accelerating reform.” This is to be achieved through four programmatic areas, including creating an environment for the development of the private sector and strengthening institutions of governance.⁶ Although there is no specific mention of microfinance in the paper, it is clear that the government views the availability and accessibility of financial services, including for the poor and microenterprises, as a key component to the development of the economy.

III. THE PALESTINIAN FINANCIAL SYSTEM

A. Overview of the Financial System

The regulated Palestinian financial system consists of the banking sector, mortgage finance companies, insurance companies, specialized lending institutions⁷ and other finance companies, money changers, and a privately operated stock exchange. Outside of the regulated system, there are various types of microfinance institutions (MFIs), including nongovernmental organizations (NGOs), for-profit and nonprofit companies and savings and credit cooperatives. (These institutions are discussed in Part IV of this report.)

The Palestinian banking sector consists of 22 banks with 138 branches. (Based on a population estimate of 3.7 million, there is 1 branch for every 26,800 inhabitants.) The 22 banks consist of 10 Palestinian banks and 12 foreign banks, including 11 Arab banks. Of these, four are Islamic banks. The size of the banking sector has increased significantly since 1993, when there were only two banks operating in the West Bank and Gaza: Bank of Palestine and Cairo-Amman Bank.

The banking system uses four currencies: Jordanian dinar, Israeli shekel, U.S. dollar and the Euro. The Palestinian Monetary Authority (PMA) does not currently have the authority to issue currency.

Although banks have more than adequate liquidity (total deposits exceeded US\$4 billion in April 2005), they are extremely conservative in their lending practices, resulting in a sector loan-to-deposit ratio that falls far short of the PMA-mandated 40% minimum per bank.⁸ Due to the lack of collateral acceptable to banks, access to bank loans is generally difficult for most Palestinians. In principle, banks take three types of collateral: mortgages, pledges of movable assets, and guarantees. However, due to the scarcity of titled land⁹ and the lack of a computerized system for registering pledges of moveable assets, the bulk of loans is secured by guarantee, and many loans to individuals are guaranteed by salaries (either of the borrower or a personal guarantor) that are

⁶ The two other programmatic areas are ensuring social protection and investing in social, human, and physical capital.

⁷ A specialized lending institution is any Palestinian institution established to grant loans for a purpose specified by the government.

⁸ At this time, the PMA does not enforce the regulation (which would require the banks to deposit the shortfall in lending with the PMA in a non-interest bearing account).

⁹ According to the World Bank paper “Stagnation or Revival?” less than half the land in the Gaza Strip and only about 30% of the land in the West Bank is registered.

paid into the bank. This situation should change in the near future because a decree authorizing the establishment of a computerized registry for movable assets was passed in May 2005. The Ministry of the National Economy (MoNE) expects the computerized system to be operational by early 2006.

As of today, there are only a few specialized lending institutions and mortgage finance companies. There are a handful of insurance companies offering life, property, and car insurance. However, there are approximately 300 money changers.¹⁰ Many of the remittances from abroad come through money changers, who do not participate in the payment system but instead use their bank accounts to receive clients' funds. Some of the money changers engage in lending (mostly against post-dated checks), although there is no official information on this activity because licensed money changers are in fact not permitted to engage in lending pursuant to the terms of their license.

The authors were not made aware of any data on other finance companies operating in the West Bank and Gaza.¹¹

The stock exchange was established in Nablus in 1995. There are 27 companies listed on the exchange, with an estimate of US\$100 million being traded monthly, although only seven companies are actively traded.

B. Infrastructure Supporting the Financial System

Payment system. There is no shared infrastructure for the payment system among the banks. Each bank is connected through the SWIFT system and has accounts with the PMA. The International Monetary Fund is currently providing the PMA with technical assistance to improve the existing payment system.

Credit bureaus. There is currently no private credit information market. The PMA collects information from banks on any borrower with a loan with a principal amount exceeding \$10,000. This information is made available only to other banks. In addition, PMA has a black list for bank customers who issue checks without having sufficient funds. This list is circulated to banks and is deemed to be confidential and is for the use of banks only. The PMA is interested in the establishment of a private credit information market, and CGAP has recently been put the PMA in touch with credit bureau experts at the International Finance Corporation (IFC).

Audit firms. There are six audit firms accredited by the Ministry of Finance and the Palestinian Authority (as well as the World Bank) to audit financial institutions. Four of the firms are affiliates of the big four international audit companies; two firms are well-established local companies. All are familiar with international audit standards but none has exposure to microfinance, the transactional risks of microfinance, or the relevant disclosure standards. The Ministry of Interior requires all NGOs to get a financial audit every year but does not specify the terms nor does

¹⁰ Although any money changer should be operating pursuant to a PMA-granted license, only approximately 50% are in fact licensed.

¹¹ There are no financial leasing companies although a draft leasing law has been discussed.

the Ministry accredit audit firms. Instead, a NGO may select any registered and certified Palestinian public accountant for its annual audit.

Deposit insurance. There is currently no deposit insurance fund. The PMA is undertaking a study on this issue even though, as underscored by the Governor of the PMA, Palestinian banks' depositors have never lost their savings. Although the International Monetary Fund has expressed some concern regarding the low percentage of deposits kept by banks in the West Bank and Gaza (30%) and the consequent risk to Palestinian depositors (if the substantial portion of Palestinian savings invested abroad by foreign banks is managed poorly), the PMA does not view the establishment of a deposit insurance fund as a matter of urgency at this time.

IV. THE MICROFINANCE SECTOR

A. Microfinance and the Demand for Microfinance Services in the West Bank and Gaza

The term “microfinance” as used in this report refers to the provision of financial services on a sustainable basis to the poor and to microenterprises,¹² including not only loans but also savings, money transfer services (including the very important service of transferring remittances), and insurance.¹³ Typically, microenterprises are initially primarily interested in credit.¹⁴ While the poor also need access to credit, they also need savings and transfer services.

Various studies and surveys have estimated the number of Palestinian microenterprises and their demand for credit, but there has not been any survey estimating the demand for other financial services, by microenterprises or by the poor. In addition, there has been no effort to measure the demand by the Palestinian poor for microloans for non-business uses (e.g., consumption loans, housing loans and education loans). As for current data on the number of microenterprises needing loans, the surveys indicate that a reasonable figure is approximately 150,000.¹⁵ The authors assume that the capital required by these businesses today is close to US\$200 million.¹⁶ It is roughly estimated that at least one-third of this demand requires borrowing in accordance with Islamic principles and an additional one-third of potential demand would prefer to borrow on Islamic terms if given the choice.

¹² A microenterprise is, in essence, any business that brings income to the family. The term refers to both registered and unregistered businesses, including individuals (microentrepreneurs) working out of the home. There is a significant overlap between the two groups—microentrepreneurs and the poor—although some microentrepreneurs are not poor and many poor are not microentrepreneurs. However, even those microentrepreneurs who are not poor tend to be particularly vulnerable to economic shocks and could easily become poor given a change in circumstance.

¹³ This report does not address the issue of microinsurance, which is generally a separately regulated business and raises distinct legal and regulatory issues.

¹⁴ However, microenterprises do require other financial services and the microentrepreneurs require financial services apart from their business needs (i.e., for their personal affairs).

¹⁵ This figure is based on surveys estimating the total number of *informal* enterprises (approximately 110,000, almost all of which are assumed to be microenterprises) and data of the Palestinian Central Bureau of Statistics on registered microenterprises (estimated by the authors to be 40,000 based on 80,000 registered enterprises, more than 95% of which are considered micro and small enterprises).

¹⁶ This is almost double the figure given in a 2003 survey that estimated the need for loan capital at US\$105 million for the informal sector. The authors' higher figure reflects a belief that the 40,000 registered enterprises would typically be bigger and require more capital than the informal enterprises.

The authors estimate the demand by the poor for small-balance savings accounts and money transfer services to be 200,000 households.¹⁷ (As noted, there is likely some overlap between the estimated 200,000 poor households and the estimated 150,000 microenterprises, because many of the microentrepreneurs would also be counted as part of the 200,000 poor households.) These are rough estimates, however, because there are no hard data currently available on the demand for these services.

As discussed below, today the Palestinian MFIs offer only microloans¹⁸ and some minor business development services. Only the savings and credit cooperatives offer savings products, and this is limited to the cooperatives' members. None of the MFIs is involved in payment transfers. In addition to legal barriers and other operational problems discussed below, the failure of MFIs to offer the full range of financial services needed by the poor is likely also due in part to the lack of clear and detailed information on current demand.

B. The Palestinian Microfinance Sector

Overview. Today there are ten MFIs¹⁹ and one commercial bank engaged in microfinance. (See Appendix D for a description of the development of the Palestinian microfinance sector.) The ten MFIs operate under a variety of institutional forms as outlined in the chart below.

Legal Forms for Palestinian MFIs in 2005

Legal Form	United Nations Agency	Int'l NGO	Local Program	Local NGO	Savings and Credit Cooperative	Non-profit Company	For-Profit Company
MFIs ²⁰	UNRWA	ANERA CHF	GWLF ²¹	ACAD ASALA ²² YMCA	PARC cooperatives ²³	FATEN	Al Amin ²⁴

Aside from UNRWA, PARC and FATEN, the MFIs are very small. The average number of active borrowers (excluding Al Amin, for which the authors were unable to get current data) is 2,690, which is a small fraction of both the global average of 47,688 and the average for Arab MFIs (25,511) based on December 2003 data of the Microfinance Information eXchange

¹⁷ The Palestinian Central Bureau of Statistics data indicate that there are approximately 500,000 Palestinian households in the West Bank and Gaza. As roughly 50% of the population lives under and around the poverty line, this calculates to approximately 250,000 poor households. The authors have discounted the 250,000 figure by 20%.

¹⁸ In the West Bank and Gaza, microlending is often blurred with SME lending. The general guideline accepted in the Palestinian microfinance sector is that a microloan has an initial principal amount of \$50 to \$5,000. An SME loan ranges in size from \$5,000 to \$25,000.

¹⁹ For purposes of this report, "MFIs" refers not only microfinance institutions but also to the microfinance programs run by organizations that also engage in other activities (e.g., UNRWA).

²⁰ All acronyms for MFIs are defined in Appendix D.

²¹ GWLF, which operates only in Gaza, was established by ANERA and a Palestinian NGO, the Culture and Free Thought Society. GWLF's activities are funded by ANERA but its loans are kept on the books of the Culture and Free Thought Society.

²² ASALA was initially established in 1997 as the Center for Women's Economic Projects. In January 2001, it registered as an NGO under its new name.

²³ A very large and well-established Palestinian NGO, PARC, has helped form and oversees twelve savings and credit cooperatives (which, given that they operate under the PARC umbrella, are treated as one for the purpose of counting the number of MFIs).

²⁴ A group of individuals established Al Amin. It operates only Gaza.

(MIX).²⁵ (See Appendix E for a table of MFIs' outreach indicators and Appendix F for the MIX benchmarking table entitled "Microfinance in the Arab World.") When PARC's savers are included, the average number of clients served by the MFIs increases to 3,155.²⁶

The sector has shifted over the past several years from making only microenterprise loans to making a variety of types of loans. (As of the end of September 2005, one third of loans made by Palestinian MFIs were consumption, housing and small loans.) Several MFIs now are engaged in a mixture of traditional microlending and higher principal balance SME lending. In addition, the clientele of the sector is now less than 50% women, less than the regional average and less than what it was before the Al Aqsa Intifada (approximately 55–60%).

Although the Palestinian poor require financial services in addition to the provision of credit, no Palestinian MFI today offers savings to the public²⁷ nor does any offer transfer services. (Some offer limited business development services.) This is in part due to legal restrictions. Only PMA-licensed deposit-taking institutions (i.e., banks) are permitted to take deposits from the public and only banks participate in the payment system. Palestinian savings and credit cooperatives are permitted to take members' savings, but not from the general public. Although MFIs could, in theory, partner with banks to provide clients with access to deposit accounts and transfer services (as money changers have done), this has not happened to date. Such bank partnerships would depend on building the capacity of the MFIs and, of course, also on the interest of banks (which is lacking at present due in part to their low familiarity with microfinance generally and their attitudes towards existing MFIs).

For several reasons, no Palestinian MFI is operating on a sustainable basis (although FATEN is close to achieving operational sustainability). The situation is due in part to the closure policy and the occupation. The MFIs that had been operating on a sustainable or close to sustainable basis prior to the Al Aqsa Intifada have since either shifted their focus (i.e., to bigger loans) or, as with all of the MFIs, experienced a decline in portfolio quality. Other MFIs have never charged high enough interest to cover their costs for various reasons: a lack of exposure to international best practices, a philosophical conviction against the charging of high interest rates, or lack of transparency, thus preventing the MFI from properly assessing its costs. In addition, only a few of the MFIs operate based on a business plan (or at least a recently prepared, comprehensive and ambitious business plan).²⁸

Furthermore, most MFIs do not have adequate (nor parallel) management information systems and many of the MFIs cannot provide on-time and accurate data about their loan programs.²⁹

²⁵ In addition, it should be noted that some of these borrowers would be considered small as opposed to micro according to the generally accepted definition referred to in footnote 19.

²⁶ Although there were 5,653 savers as of Sept. 30, 2005, all of the PARC borrowers are assumed to be savers so the total number of clients increases only by 4,646 (5,653 savers minus 1,007 borrowers).

²⁷ As noted, the PARC cooperatives provide savings services to members.

²⁸ In fact, some MFIs did have a business plan prior to the Al Aqsa Intifada but have not updated it and are today generally working based on monthly or quarterly projections (and in the best case, annual plans). Some MFIs have never developed a business plan. Some MFIs tried to do 3–5 year projections but failed to involve the relevant staff, producing a document that was neither comprehensive nor helpful for business planning.

²⁹ Palestinian MFIs also have low staff productivity (65–70 borrowers/staff member) when compared to the average for Arab MFIs (138 borrowers/staff member) and globally (136 borrowers/staff member). Even those Palestinian

And, as there are no agreed disclosure standards for the MFIs, it is difficult to obtain comparable and reliable information on MFIs' performance, particularly portfolio quality and profitability.³⁰ This lack of transparency leads directly to a lack of accountability on the part of each MFI and also presents a problem for MFIs wishing to access (or which might in the future need to access) commercial sources of capital.

Lending-Only MFIs. The lending-only MFIs, which today are the main providers of microloans in the West Bank and Gaza, offer a variety of loan products: individual and group loans, housing loans, Islamic loans, agricultural loans and consumer loans. For individual loans, the borrowers are required to give some form of collateral. Predominantly, this involves the use of post-dated checks, a type of registered promissory note (*sanad dayn monazzam*), a personal guarantee of a third party or a form of direct deposit of a wage-earning borrower's salary into a bank account of the MFI.³¹ FATEN and ASALA collect compulsory savings in connection with their group lending programs.³² It is possible that MFIs will start taking more traditional collateral in the form of pledged assets following the establishment of a computerized registry for movable assets.

To reduce costs, most of the NGOs use banks for disbursement and for collection of loans and collateral. However, as observed above, none of the MFIs has any form of partnering arrangement with a bank to offer other services to the MFIs' clients.

PARC Savings and Credit Cooperatives. Twelve of the 21 operating savings and credit cooperatives were established by, and operate under the aegis of, PARC, a well-established NGO.³³ The 12 PARC cooperatives cover all of the districts in the West Bank and Gaza with 132 locations and currently reach over 5,600 members. As of September 2005, the PARC cooperatives had an outstanding loan portfolio of over \$1.8 million with just over 1,000 borrowers (all of whom are women) and held almost \$1.5 million in members' savings. Although the cooperatives were established during the Al Aqsa Intifada³⁴ and although the network of PARC cooperatives has quickly become the second largest MFI in terms of outreach (a laudable achievement during this difficult period, especially given that the cooperatives are the only Palestinian MFIs to offer a voluntary savings product), they are not operated on a sustainable basis (i.e., the interest rates on

MFIs serving only microclients (and not serving SMEs) have low staff productivity (lower staff productivity is expected for SME loan).

³⁰ Apart from the major 5–6 indicators which SANABEL Microfinance Network of Arab Countries collects from Palestinian MFIs through the Palestinian Microfinance Network, the authors did not see any further data collection on the financial performance of these programs nor any attempt by the Network to provide any kind of benchmarking. This is due not only to the MIS problems and lack of reporting standards but also to the lack of training in financial analysis.

³¹ The use in the West Bank of the *sanad dayn monazzam* for microloans is limited due to the registration fee of 200 NIS or approximately \$50, which would constitute an exorbitant cost for a typical microloan.

³² These are usually very tiny amounts; for each borrower, the savings amount is always less than the balance of their loans.

³³ The authors met only with PARC (and not with any of the savings and credit cooperatives it has organized) and our comments therefore are limited to what was learned from PARC. (ACAD has a program to assist the Union of Palestinian Farmers in establishing cooperatives that take savings as one component of a broader range of agriculturally related cooperative activities. As of July, they had established 41 cooperatives with 1,560 members and had collected over \$380,000 in savings.)

³⁴ Before the establishment of the cooperatives, PARC was involved in microlending. PARC no longer engages directly in microlending today.

loans are not set on a cost-covering basis). This poses a risk to their future operations and severely limits the possibilities for expansion, both in terms of numbers of members served and variety of products offered. It also raises concerns as to the long term security of members' savings, particularly as donor subsidy becomes less abundant. In addition, there is no funded position within PARC to work specifically with and provide technical assistance to the cooperatives. Instead, the work is undertaken by PARC staff who are also working on other initiatives as well as by the coops' member-elected committees.³⁵ This lack of dedicated PARC staff translates into inadequate attention to the development of the individual cooperatives, the training of loan staff and the development of appropriate products (both loan and savings).

Banks. There is one bank—Bank of Palestine—currently engaged in microlending. (Previously, Arab Bank and Bank of Jordan had USAID-supported microlending programs but both ended during the Al Aqsa Intifada.) Bank of Palestine commenced its microlending program in April 2005, began extending loans in July and as of mid-September had approximately 400 active clients. It is running its operations according to international best practices and charges cost-recovering interest rates. Most of the other commercial banks are interested in SME lending rather than microlending, which they perceive as more risky due to the absence of collateral.³⁶

Although in the West Bank and Gaza there is an extremely high ratio of bank branches to population *and* the branches offer savings accounts, no bank does any substantial business in small-balance deposit accounts. This is largely due to the typical barriers for the poor to access banks, both for loans and deposit accounts. The banks have an image of the poor as nonbankable or at least not a source of profitable business³⁷ and, largely as a consequence, the poor are generally not comfortable entering a bank (although this may be less of a problem in the West Bank and Gaza, where many of the poor are only recently poor due to the political situation). In addition, for those poor who live in remote areas and rural areas, it is not easy to travel to bank branches (which are located in the main cities). This is a particularly acute problem in the West Bank and Gaza, as there are extreme difficulties in movement in general due to the roadblocks and, for some, the wall constructed by Israel. Thus far, the banks in the West Bank and Gaza have not been innovative in attempting to lower the cost of taking deposits,³⁸ nor have they tapped into the substantial business of transfers of remittances.

A new bank—Al Rafah Bank—being established by leading Palestinian businesses (including PADICO, PalTel and Birzeit Pharmaceutical) to engage in SME and microfinance is expected to begin operations in the near future. The founders have committed \$12.25 million; it is expected that following a public offering, the bank's initial capital will total \$30 million (well above the \$20 million minimum required by the PMA). The bank is in the early stages of designing its

³⁵ The committees both propose the loan application and approve it, thus leading to potential conflict of interest problems.

³⁶ As noted, the banks are conservative in their lending and generally require 100% collateral, which is impossible for most poor clients to provide. Cairo Amman Bank has expressed an interest in microfinance although currently it is inclined to focus initially on the SME market.

³⁷ In fact, according to the General Manager of Cairo Amman Bank (CAB), opening savings accounts for the poor is *not* a profitable business. He estimated that it would cost CAB about 2.5 JD to use a teller to take a deposit. If the client is depositing 5 JD, it's a money-losing proposition.

³⁸ This may be in part due to their already very high rates of liquidity.

products and planning its operations but lacks exposure to the practices of banks successfully engaged in microfinance in other countries.

Money Changers. Although money changers are not generally thought of in the West Bank and Gaza as part of the microfinance sector, many of them do engage in microlending (i.e., loans of \$5,000 or less). In addition to making loans (typically collateralized by post-dated checks), they receive remittances, cash checks and exchange currency. As noted above, only an estimated 50% of money changers hold licenses for this activity from the PMA, and their licenses technically do not permit them to engage in lending activity of any sort.

The Palestinian Microfinance Network. The Palestinian Microfinance Network was established in 2002 (although it received its official registration certificate in April 2004) with the assistance of USAID to create linkages among the NGOs engaged in microfinance and SME lending. The members consist of all of the MFIs other than GWLF; there are no bank members nor are any money changer members. Currently, the Network is focusing its work on coordinating the actions and communications of its members vis-à-vis other actors in the financial sector and policymakers³⁹ and identifying the needs of the microfinance sector. As reported by the Network, these needs include (i) technical assistance for capacity building with emphasis on reporting, MIS and staff training, (ii) developing the sector through support of the Network and individual MFIs as well as other institutions, (iii) improving the legal environment for MFIs and (iv) raising capital. The ability of the Network to accomplish its objectives is currently limited given the lack of funds, paid staff and other institutional support.⁴⁰

C. Donor Funding for Microfinance

The Palestinian microfinance sector, as well as the banks who have in the past run microfinance programs, have benefited over the past ten years from significant donor funding, which, by some very rough estimates, has exceeded US\$50 million for technical assistance and loan funds. USAID, roughly estimated to have provided more than US\$30 million, has thus far been the primary donor supporting the development of microfinance in the West Bank and Gaza.

All the MFIs (aside from Al Amin, which is entirely funded by private individuals) have relied and continue to rely on grants to finance both loan capital and operational costs. None of the MFIs has obtained commercial financing outside of donor-sponsored programs.⁴¹ Today, donors in the West Bank and Gaza, as elsewhere, are increasingly interested in providing loan funds (as opposed to grants) for loan capital. This increases the need to improve transparency, productivity, and efficiency.

With respect to donor funding for microfinance for the period 2004–2006, the West Bank and Gaza is estimated to be the third largest recipient in absolute terms in the Middle East North Af-

³⁹ As in many countries, the Network is an association of members with different and sometimes conflicting interests.

⁴⁰ The Network did have a full-time director that was funded by USAID. When the USAID project ended, the network did not have the funds to continue employing a director. Currently, the Network has no staff and all work is done on a voluntary basis by its members.

⁴¹ After the authors' second mission in September 2005, ASALA signed a \$100,000 four-year loan agreement with Cordaid.

rica region. An estimated \$39 million has thus far been allocated by donors for microfinance development during this three-year period. However, there has never been any explicit effort at donor coordination on microfinance.⁴² From the information gathered by the authors, the near-term plans for donor funding of microfinance activities include:⁴³

- USAID—a \$5 million grant awarded to FATEN in 2005. Although USAID has been the main funder of the Palestinian microfinance sector (having provided the bulk of foreign assistance to Palestinian MFIs and supported two successful bank downscaling programs before the Al Aqsa Intifada), it has no active projects planned for 2006.
- AECI/Spain—a credit line of up to Euro 10 million to Palestinian MFIs to be managed by the Ministry of Finance, together with Euro 700,000 for technical assistance and MFI capacity building that will include the cost of a microfinance advisor. AECI is interested in working with CGAP on a capacity building program.
- IFAD—financial and technical support to PARC for its network of cooperatives, with a total grant of \$ 1.1 million. The project is expected to end in 2006.
- IFC—technical assistance for the start-up phase of the Al Rafah Bank. IFC is also considering providing technical assistance to other banks interested in offering microfinance products and investment in Al Rafah bank.
- Islamic Development Bank—a proposed loan of \$19 million and a grant of \$2 million that will be channeled through an arrangement established with the Ministry of Labor (MoL) to MFIs to make loans to the poorest.
- European Union—no direct involvement in microfinance although some European NGOs (SIDI, NOVIB) that are providing grants to Palestinian MFIs are funded under the EU global NGO program. The EU food security program is also lobbying for a new microfinance law (discussed below).
- Grameen Abdulatif Jameel initiative—looking at providing technical assistance and funding to some Palestinian microfinance institutions.
- KFW (Germany)—On December 13, 2005, KFW established, with EIB assistance, the European Palestinian Credit Guarantee Fund (EPCGF) with at total capital of Euro 29 million to cover part of the credit risk of commercial banks lending in SME. In addition, KFW and EIB will also provide technical assistance to the EPCGF and to local banks to enhance their SME lending and operation.
- PlanetFinance (France)—developing a project to provide technical assistance to MFIs, the Palestinian network of MFIs and Bank Al Rafah.

⁴² The MoP is developing a new consolidated database that will track donor support as well as aid disbursed by international agencies (UN, World Bank, EC) and NGOs.

⁴³ In addition, although UNCDF/UNDP has no current microfinance project, it has expressed interest in working on policy issues with Ministry of Planning.

- Portland Trust (UK)—preparing a project to strengthen MFI capacity in the West Bank and Gaza and is coordinating its activities with CGAP and other donors. The project will be finalized during the first quarter of 2006.

Although the donor funds outlined above are, for the most part, earmarked for specific purposes and specific MFIs, there are substantial opportunities for donors to fund the important capacity-building measures for MFIs and banks (as detailed in Part VI, Recommendations).

V. CURRENT LEGAL AND REGULATORY FRAMEWORK FOR MICROFINANCE IN THE WEST BANK AND GAZA

A. Legal System and Legal Reform Measures

There is not yet a fully integrated Palestinian legal system. The laws of the West Bank and the Gaza Strip derive from two different systems: the system in the West Bank is based on Jordanian law; the system in Gaza is based on British rule and includes laws dating to the British Mandate and the Ottoman period as well as Egyptian administrative orders. There are also Israeli military orders applicable in both areas.⁴⁴ The previously existing laws and regulations in the West Bank and Gaza continue to have force and effect (to the extent not amended or repealed by Palestinian law) until explicitly repealed by Palestinian law.

Since 1994, there have been efforts at legal reform resulting in the passage of some new Palestinian legislation applicable to both the West Bank and Gaza, including the following financial sector laws: the Law on the Palestinian Monetary Authority, the Banking Law, the Law on the Capital Market Authority and the Securities Law. In addition, a decree regarding the pledging of movable assets and the establishment of a computerized registry was passed in mid-2005 (and is expected to be followed with a law with similar if not near-identical content). There have also been drafts (and in some cases, several varying drafts) of laws on competition, company law, insurance, leasing, intellectual property rights and other issues relevant to the operation of the financial system and financial institutions. However, much work remains to be done, including the drafting and adoption of implementing rules and regulations for those laws which have been passed, as the absence of implementing rules leaves open the risk of arbitrary and informal decision making by the responsible governmental authorities. In 2005, the MoNE undertook primary responsibility for overseeing the prioritization of legal reform projects. However, this is a substantial undertaking and, as far as the authors are aware, the MoNE has not yet made any public statements regarding its work in this arena.

A draft microfinance law was prepared by consultants on behalf of the European Union's Food Security Program. As far as the authors are aware, this has not yet been introduced formally into the parliamentary process. The draft includes provisions for a deposit-taking form of microfinance institution, but does not include specific provisions regarding the supervision of deposit-taking MFIs or the supervisory challenges that the PMA would face if it were given supervisory jurisdiction. (The authors are also unaware of any analysis conducted by the draft's authors to justify the creation of a new discrete legal form for microfinance.)

⁴⁴ East Jerusalem, which is not covered by this Report, is subject to Israeli law.

B. Legal Forms Currently Available for Engaging in Microfinance

1. Non-Bank Legal Forms

The MFIs operate through various legal forms: local programs of international NGOs and UNRWA (including the Gaza-based program set up by ANERA together with a local NGO), local NGOs, cooperatives, a for-profit company and a nonprofit company.

The NGO MFIs are formed under the Law of Charitable Associations and Community Organizations (Law on NGOs) and are registered and overseen by the Ministry of Interior (MoI).⁴⁵ The PARC savings and credit cooperatives are formed under the Gaza and West Bank Laws on Cooperatives (which govern cooperatives of all types, not just financial cooperatives).⁴⁶ All Palestinian cooperatives register with and report to the MoI. The for-profit company was formed under the Gaza Companies Law; the nonprofit company was also formed under the Gaza Companies Law, but prior to the adoption of the Law on NGOs.⁴⁷ Both companies report to the MoI. Although none of the MFIs is registered, regulated or supervised by the PMA, applicable law permits the PMA to register, regulate and supervise any finance company,⁴⁸ which could be interpreted to include microfinance companies (but not microlending NGOs and savings and credit cooperatives, over which the PMA clearly has no authority). However, the PMA has explicitly stated that at the present time, it has no intention of bringing the MFIs under its authority.

2. Banks, Specialized Lending Institutions and Other Finance Companies

The banks are licensed, regulated and supervised by the PMA, which has general responsibility for the stability of the banking and monetary system and for encouraging economic growth. The PMA issues circulars and sends regulations directly to the banks. (These regulations are not published or otherwise made publicly available.)

Specialized lending institutions, which engage in lending to meet a specified government objective, may engage in microlending.⁴⁹ These types of institutions are licensed, regulated and super-

⁴⁵ All NGOs are overseen by what is determined to be the “Competent Ministry,” which is to be determined by the NGO Department of the Ministry of Interior (MoI) based on the specific activities of the NGO.

⁴⁶ There is one law on cooperatives in the West Bank and one in Gaza. They are likely to be superseded in the near future by a Palestinian law on cooperatives.

⁴⁷ It is highly unlikely that a Palestinian nonprofit company could be formed today given that there is no Palestinian law on nonprofit companies and the West Bank provisions governing nonprofit companies have been repealed. The Gaza companies law implies that nonprofit companies may exist but there are no detailed provisions governing their operations.

⁴⁸ The term “finance company” is defined in the Banking Law as any company that, in its constituent documents, has as a stated objective “to conduct financial transactions regarding financing development projects, investment, managing investment funds and brokerage (agents) in accordance with” the Banking Law. According to the Banking Law, finance companies may engage in banking activities. “Banking activities” are defined as “all banking services including accepting deposits and using such deposits together with all other resources of the Bank in investment, in part or in full, in lending or any other activity permissible by law.”

⁴⁹ The Palestinian Banking Corporation, a specialized lending institution that was established in 2001 by the Palestine Development Fund (a nonprofit organization), engages in SME lending although it is a member of the Palestinian Microfinance Network.

vised by the PMA. Nothing in the legal or regulatory treatment of these institutions warrants comment here.

There are no restrictions on the ability of finance companies (including mortgage finance companies) to engage in microfinance. Nothing in the legal or regulatory treatment of finance companies warrants comment other than the question of the proper regulator. As stated above, the law provides that the PMA is responsible for licensing, regulating and supervising finance companies. However, the recently adopted Capital Market Authority Law provides that the to-be-established Capital Market Authority (CMA) will (i) supervise the financial leasing companies⁵⁰ and mortgage finance companies (as well as the securities market and insurance companies)⁵¹ and (ii) “monitor the development of non-bank finance companies in a manner to ensure their proper functioning.” According to the PMA, the inconsistencies between the two laws are being addressed and it is expected that the necessary legislative amendments will be adopted in the near future.

C. Legal Issues Particular to Microfinance

I. NGOs

NGO MFIs face a number of legal and regulatory issues by virtue of the fact that they operate under the new Law on NGOs—the only legal form currently available to MFIs wishing to operate on a nonprofit basis.⁵² The NGO legal form is far from ideal for developing sustainable microlending institutions for several reasons.⁵³ First, the NGO MFIs are overseen by the MoI—not the appropriate body to be regulating an organization engaged in a financial business. Second, the law requires that all legal documents, including checks, be signed by the chairman. Although it is possible to delegate signatory authority by means of a proxy, the MoI generally does not approve such proxies in practice. This restriction is extremely limiting for the efficient operation of any MFI, especially for those with clients in multiple locations.⁵⁴ Furthermore, the restriction imposes a heavy burden on the chairman, a position that by law may not be compensated. Third, NGOs by definition may not raise equity from investors. Any increase in balance sheet equity is limited to retained earnings and funds received from donors. For these three reasons, it is unlikely that NGO MFIs will be able to expand operations significantly, which would be necessary if these MFIs, together with the banks, are going to meet the demand for microfinance services.

⁵⁰ There is currently no law governing financial leases and no leasing companies.

⁵¹ It is expected that an EU study of financial sector legislation will outline the problems with having one regulatory authority responsible for such wide-ranging and divergent segments of the financial sector.

⁵² As noted above, there is one MFI operating as a nonprofit *company*, a distinct legal form that existed under Gaza law at the time the MFI was formed, but which has since been eliminated as an option for future MFIs wishing to operate on a nonprofit basis due to an amendment in the law.

⁵³ These problems are not faced by PARC, which does not itself engage in microfinance but instead runs a program overseeing the activities of 12 legally independent savings and credit cooperatives.

⁵⁴ Of course speedy service, which is usually a critical concern for microclients, is necessarily compromised when check signing is centralized.

2. Appropriate Regulator and Regulation⁵⁵ for Lending-Only MFIs

Currently there is no single regulator for MFIs. The responsible ministries for the various legal forms engaged in microfinance are, respectively: the MoI for NGOs (including for microlending programs of international NGOs); the MoNE for companies (including the one MFI operating as a nonprofit company); and the MoL for cooperatives. Although this situation does not necessarily counsel for the establishment of a new regulatory body or a new regulatory system specifically for microfinance (discussed further in connection with the existing draft of a separate microfinance law), it would be helpful to the growth and development of the microfinance sector if the government body or bodies overseeing the sector were familiar with finance. The two most natural options are the PMA (which has not expressed an interest in taking on this responsibility today) and the MoNE (whose Minister also did express any such interest to the authors).

3. Appropriate Regulator for Savings and Credit Cooperatives

As previously noted, all cooperatives, including savings and credit cooperatives, are regulated by the MoL—the ministry also responsible for overseeing the affairs of non-financial cooperatives. However, the issues presented by savings and credit cooperatives can be quite different from the other types of cooperatives, especially given the risks and responsibilities associated with taking members' savings. In other countries, the trend is to impose some prudential regulation on savings and credit cooperatives (although not to the extent of typical banking regulations as the cooperatives do not generally take savings from the *public*), and to assure the regulatory body assigned the task is one with the requisite expertise to execute prudential regulation effectively. This is an issue that must be addressed sensitively in order not to burden unduly the efforts of the cooperatives to provide much-needed deposit-taking services to the Palestinian poor.

4. Tax Treatment of For-Profit MFIs

Although an MFI may establish itself as a for-profit company, thereby avoiding the legal and operational problems associated with the NGO legal form discussed above, this would place the for-profit MFI at a significant comparative disadvantage vis-à-vis other actors in the market. The NGOs, the cooperatives and the one nonprofit company enjoy public subsidy in the form of tax-exempt status, to which for-profit MFIs are not entitled.⁵⁶ An MFI established as a for-profit company is also at a disadvantage vis-à-vis banks and PMA-licensed finance companies, in that it does not benefit from the deduction for loan loss reserves permitted for such regulated enti-

⁵⁵ The type of regulation referred to here is not prudential regulation, aimed at protecting the solvency of the regulated institutions, but rather transparency-driven regulation, focused on standardized measures of MFI performance and the public reporting of such performance. Prudential regulation requires much more specialized skills and understanding of the dynamics of a financial business on the part of the regulator; however, even transparency-driven regulation is best executed by a regulatory body with sufficient ability at least to understand the performance data reported.

⁵⁶ Of course, an NGO MFI would only be entitled to tax exempt treatment regarding income and other taxes (e.g., customs taxes) if its activities are in accordance with the objectives stated in its by-laws. An MFI that has no social objective would not be entitled to tax-exempt treatment.

ties,⁵⁷ nor does it benefit from the deduction that may be taken by banks and licensed finance companies for VAT paid on staff salaries.

D. Broad Financial Sector Legal Issues Relevant to Microfinance.

As is commonly known, the legal system in the West Bank and Gaza is severely impeded by the general problems of enforcement stemming from the extremely weak state of the judiciary. Aside from this significant overarching problem (which is the subject of much work by the Palestinian government and donors), there are several broad legal and regulatory issues that are relevant to the operation of financial institutions generally, including MFIs:

Collateralized Lending. Virtually all lending in the West Bank and Gaza, whether by commercial banks or by MFIs, involves collateralized or at least semi-collateralized loans. Currently, the predominant form of collateral is a guarantee. In the absence of a guarantee, banks generally require direct salary deposit into a bank account which can be offset to pay any amounts due under a loan. This mechanism, however, is obviously not available to microbusinesses and the poor who do not have salaried employment. Both banks and MFIs often require borrowers to deposit post-dated checks (which are then cashed in the absence of a timely loan installment payment), although it is a criminal offense knowingly to issue a check in excess of the amount in one's bank account.

Pledges of assets and mortgages (which would be more common for banks than for MFIs) are rare, due, in the case of pledges, to the fact that there is currently no computerized registry for moveable assets and, in case of mortgages, to the fact that less than half of the land in the Gaza Strip and only about 30% of the land in the West Bank is registered. In May 2005, the Cabinet adopted a decree on moveable assets that authorized the establishment of a computerized registry to be housed in the MoNE. A law with similar content is expected soon to be adopted. There is also a major effort underway to address the land-titling issue.

Interest rate policies. The PMA's stated position regarding interest rates is to not set maximum rates but rather leave them to be determined by the market.⁵⁸ (In support of transparency, the PMA does require banks and other finance companies to disclose interest rates and commissions through publication in a visible place in their branches.) Thus, the issue of caps on interest rates is not an issue for lenders today. However, lenders are vulnerable to the possibility that there may be a change in policy in the future, as the PMA in fact *has* the authority to set interest rate caps pursuant to the Law on the PMA.

Two other laws beside the Law on the PMA complicate the interest rate picture. First, an Ottoman law specified a maximum interest rate of 9% with additional restrictions. Although an Israeli military order repealed the Ottoman law, Palestinian courts continue to apply the 9%

⁵⁷ The definition of "finance company" is very broad. However, it appears that an MFI that is not regulated by the PMA (as is currently the case for lending-only microfinance companies) and therefore not required to set aside loan loss reserves would find it difficult to argue that it is entitled to take the deduction permitted for regulated finance companies.

⁵⁸ The PMA did explicitly identify, in a March 2004 PMA circular, the services and transactions on which the banks may charge fees and commission. Interestingly, the PMA also stated in the circular that it hopes that fees and commissions charged by the banks will be "reasonable."

interest rate cap on collection of JD-denominated loans (and certain Magistrate judges refuse to enforce the collection of any interest). Second, a 1972 Israeli military order gave the Supervisor of Banks of the Bank of Israel the authority to set interest rates with the approval of the Officer commanding the Territories. (The order could be interpreted to apply only to Israeli shekel loans.) This order remains effective until repealed or amended by the competent Palestinian authority.

Regulators. Due to ambiguities in the interplay between the Law on the PMA and the Law on the CMA mentioned above, it is unclear whether the PMA or the CMA should regulate certain finance companies. (According to the Law on the PMA, the PMA is responsible for regulating finance companies, a term which is broadly defined in the law. However, the CMA is specified in the Law on the CMA as the regulator of certain specific finance companies, such as mortgage finance companies.) As previously noted, the PMA acknowledges that there are ambiguities and plans are in the works to amend the PMA Law to clarify the division of responsibility between the PMA and the CMA. It will be important that the amendments clarify whether the PMA is to be the regulator of all finance companies *not* regulated by the CMA (including lending-only companies), which will determine which government body regulates MFIs.

Diverse Responsibilities of the To-Be-Established Capital Markets Authority. As noted previously, the recently adopted Capital Market Authority Law provides that the to-be-established CMA will (i) supervise the financial leasing companies and mortgage finance companies as well as the securities market and insurance companies and (ii) “monitor the development of non-bank finance companies in a manner to ensure their proper functioning.” The general problems caused by the creation of a single regulatory body with such diverse and divergent areas of responsibility has been addressed by a October 2005 report of the European Commission entitled “Status of the Economic & Financial Legislation in Palestine,” and is therefore not discussed further in this report.

Anti-Moneylaundering Law and Laws on Combating of Financing of Terrorism. There exists one PMA circular from December 2001 prohibiting money laundering. There is currently no regulation or legislation addressing the issue of terrorist financing. USAID is currently providing technical assistance on the issues of anti-moneylaundering and the combating of financing of terrorism. Although these two issues need to be properly addressed in the law, it will also be important to monitor any legislative developments to ensure that the requirements are established with due respect to the administrative burdens imposed on providers of microfinance services and to the specific level and type of risk presented by such institutions.

VI. RECOMMENDATIONS FOR POLICYMAKERS AND DONORS⁵⁹

The above assessment of Palestinian microfinance sector and the identified obstacles to access to financial services for poor people and microbusinesses in the West Bank and Gaza present a challenging picture. It is nonetheless possible to envision increasing the number of clients served and range of services available from the current modest figure of approximately 27,000 clients (which includes both small and microclients), most of whom have access only to loans delivered by unsustainable institutions, to 100,000 clients served by a full range of financial services deliv-

⁵⁹ See Appendix G for detailed breakdown of the timeframe for the primary recommended actions.

ered by strong, economically viable financial service providers. With this ambitious goal in mind, CGAP's recommendations to donors and government officials, outlined in detail below, cover six broad areas: (i) capacity building for the various actors; (ii) the infrastructure supporting microfinance as well as transparency and accountability of MFIs; (iii) funding; (iv) the regulatory and policy framework for financial institutions providing such services; (v) a government policy toward poor Palestinians who are not ready to be consumers of conventional microfinance services; and (vi) better analysis of unmet demand for financial services among the Palestinian poor and microenterprises.

A. Capacity Building

Aside from the savings and credit cooperatives, Palestinian MFIs' activities currently are essentially limited to extending microloans. (A few MFIs offer some business development services.) To expand the services offered by MFIs—including offering services through partnerships with banks—and to improve outreach, the MFIs require various capacity-building measures.⁶⁰ In addition, it is important that banks—which have excessive liquidity but little interest currently in serving the lower income sector of the economy—be introduced to the microfinance business (or, in the case of Arab Bank and Bank of Jordan, reintroduced to a product line that they had developed successfully before the Al Aqsa Intifada). This is the most promising avenue to scale up microfinance in the West Bank and Gaza.⁶¹

MFIs' capacity. In general, the Palestinian MFIs all need assistance in three major areas: (i) business planning, (ii) management capacity and (iii) MIS and reporting. Without improvement in these areas, it is unlikely that an MFI could achieve sustainability and significant growth. CGAP proposes that MFI managers and senior staff attend the CGAP/SANABEL courses for managers, which include various topics (including financial analysis, operational risk management, delinquency management and interest rate setting, product development, business planning and financial modeling). In addition, it is recommended that each MFI be invited to engage with selected consultants in a business planning exercise. (Future donor funding should only be made available to those MFIs that have developed such a business plan.) Finally, CGAP recommends that the more well-established MFIs be rated by a rating agency specialized in microfinance. CGAP's rating fund program (www.ratingfund.org) would be able to cover up to 80% of the cost of the rating.

Commercial banks' lack of involvement in microfinance. Most of the commercial banks operating in the West Bank and Gaza today are interested in SME lending rather than microlending, which is perceived as more risky due to the absence of collateral.⁶² And it appears that no bank is interested in offering deposit accounts to the Palestinian poor and microbusinesses. If banks are to be convinced that microfinance is a viable business, they need to be properly informed about the dynamics of serving poor clients profitably and for this they will need to receive training.

⁶⁰ One specific measure proposed by a Palestinian MFI would be to provide training to MFI board members on the importance of efficiency and sustainability to an MFI's operations.

⁶¹ This has been the case in Egypt, where Banque du Caire, before its recent acquisition by another large Egyptian bank, had 100,000 clients after only three years of microfinance operations.

⁶² Cairo Amman Bank expressed an interest in microfinance although currently it is inclined to focus initially on the SME market.

CGAP has met with three interested banks (Bank of Palestine, Cairo Amman Bank and Bank of Jordan) and will work with other donors to follow up on this preliminary contact and arrange for the provision of technical assistance to such banks, which would primarily focus on two microfinance services: microlending and deposit-taking from microclients. Some bank awareness-building workshops targeting Palestinian bankers could be organized in association with the PMA.

Al Rafah Bank. Because of the prominence that Al Rafah Bank will have (given its founders' stature and the fact that the sole focus will be microfinance), it is especially important that the bank be operated in accordance with recognized international best practices. IFC PEP MENA is in the process of signing a technical assistance agreement with the bank. CGAP strongly recommends that the bank be provided—prior to its opening—exposure to successful microcredit banks (notably the network of ProCredit banks) and the technical assistance of a leading international consulting company.

Cooperatives. Cooperatives could serve a very important function for the Palestinian poor by providing a facility for both lending and savings products. As of September 2005, the 12 PARC cooperatives held almost \$1.5 million in members' savings. CGAP recommends to prepare a mission in which an expert in credit union development will evaluate the PARC program and design a new project that will then be reviewed by and discussed with PARC, IFAD (which has funded the development of the PARC savings and credit societies) and other interested donors.

The Palestinian Microfinance Network. The Network might play an important role in facilitating capacity building, promoting policy awareness, disseminating information and serving as a forum among its members. However, without strong leadership and a clear vision, networks can be dysfunctional and ridden with conflicts between the leading and the smaller institutions. CGAP invites the Palestinian network to develop a proposal outlining its vision and its goals for the next three years as well as its proposed activities. This proposal could serve as the basis for negotiating with interested donors a performance-based grant agreement.

B. Infrastructure Supporting Microfinance; Transparency/Accountability

Support for Development of Credit Information Market. The establishment of a private credit bureau is typically very helpful in bringing down the costs associated with lending. A credit bureau can (if well run, with accurate and up-to-date information) provide a lender with an inexpensive means of assessing the creditworthiness of many potential new borrowers. Provided that the data are accurate, this can reduce risky lending and thereby ultimately reduce loan delinquency. As noted above, the PMA has been put in touch with specialists within IFC to discuss the establishment of a credit bureau. It is recommended that there be no minimum principal amount for the loans that would be reported to the credit bureau. (Any minimum would likely be higher than the average microloan and thereby render the database unusable for typical MFIs.) It is also important that the database include both negative and positive payment history data.

Audit firm quality. Most of the MFIs' financial auditors are weak vis-à-vis microfinance; they follow principles suited for nonprofit organizations but inadequate for organizations engaged in financial transactions. CGAP recommends that the Ministry of Finance (MoF)-accredited audi-

tors attend CGAP's one-day auditor training program where they will be exposed to the specific risks of microfinance transactions and familiarized with microfinance operations and disclosure standards. As a second step, the PMA could develop a list of qualified auditors (building on the list of the Ministry of Finance) as well as standardized terms of reference for microfinance institutions' audits.

Reporting Standards. Currently, the MFIs do not observe standard business reporting procedures as defined by the MIX (the leading organization specializing in statistics and financial benchmarks in microfinance), and most do not have adequate MIS. It is thus very difficult to get credible information on MFI financial and outreach performance; information on profitability, efficiency (transaction costs) and portfolio quality is not produced in a reliable and consistent manner. This creates a lack of accountability and undermines the ability of MFIs to raise funds from donors and investors. Donors should be encouraged to fund the following technical assistance:

- *Upgrade the current MIS software.* The first advisable step is to conduct a CGAP consumer review of the local MIS software to evaluate its strengths and weaknesses and identify areas for improvements. It is proposed that donors fund the recommended upgrades.
- *Adopt financial reporting standards.* MFIs should receive training on International Financial Reporting Standards and industry-specific disclosure standards established by the MIX. MFIs receiving donor grants should be required to submit reports in accordance with the established standards.
- *Develop simple business processes and software.* The PMA and the Network should work together to collect, process and consolidate MFIs' reporting data and produce benchmarks. The MIX could provide valuable assistance and software on benchmark production and dissemination. (The MIX and SANABEL work together on this in the Arab region and have materials in Arabic.)
- *Training courses.* MFI staff should attend courses in financial analysis, financial benchmarks and ratio usage, both to facilitate the development of the transparency infrastructure described above and to make the results more reliable. (This could be done during the training courses recommended above.)

It is important to note that the transparency infrastructure recommended above is not only concerned with financial performance. Measuring outreach and impact is also important to build awareness of the benefits of microfinance and help MFI managers improve their products and services and ultimately attract interest from commercial sources of refinancing (as discussed below).

C. Funding

Long-term availability of funds should not be the main problem for most Palestinian MFIs given the excess liquidity in the banking system.⁶³ However, all Palestinian MFIs (except for Al Amin,

⁶³ This is not the case for UNRWA, which is not legally permitted to borrow and has clearly expressed the need for additional funds. For this reason—which prevents the program from developing into a sustainable operation independent of donor funds—and others related to the problems of microfinance program being housed in an agency that

which is privately funded) currently are 100% dependent on donor funds.⁶⁴ While this situation may be workable today, it soon will not be if MFIs are going to meet the shortfall in supply of microfinance services. In addition, as in all countries, donor funds will not be available indefinitely. Thus it is essential that MFIs become able to access commercial funds. This depends in large part on the MFIs improving their operations and becoming profitable enough to cover not only existing operating expenses, but also a market-based cost of capital. It also depends on the appetite of commercial banks to take certain lending risks which they currently are not willing to do in any sector of the economy. CGAP has the following recommendations:

- *Performance-based grants.* Although more limited in effect, CGAP also recommends donor-funded, performance-based grants for MFIs that have developed a business plan for sustainability and growth and that are utilizing commercial funding. This may be an effective use of the technical assistance funds that the Spanish are planning to provide.
- *Guaranteed loans/grants to MFIs.* To encourage the development of bank-MFI relationships and introduce MFIs to commercial borrowing, CGAP recommends that donors establish a program providing incentives for bank-MFI linkages.⁶⁵
- *Guarantee fund for banks engaged in microlending.* CGAP also endorses the establishment of a guarantee fund—designed according to best practices (e.g., with a reasonable, not excessive guarantee percentage—that will support direct bank microlending for a limited amount of time (for example, the first two years).⁶⁶ It maybe beneficial to discuss with GTZ the extension of their program to support developing one or more banks' microfinance portfolio.

D. Regulatory and Policy Framework

Government role in supporting microfinance. The Palestinian government can best support the sector both through donor coordination and as enabler (as opposed to direct service provider).

This report documents significant donor funds allocated for microfinance over the next few years. Although the MoP is the body responsible for donor coordination, the principal government document guiding donor activity—the Medium-Term Development Plan 2005-2007—does not include any discussion of access to financial services for the poor. Without clear language on this subject in the MTDP, the MoP cannot effectively coordinate donor work (nor government activity) in this area. More importantly, without such language, the government lacks a clear basis for rejecting proposed aid that could have a counterproductive impact on the development of microfinance or for seeking to re-channel any such proposed assistance into other activities likely to contribute positively to the scaling up of the sector. CGAP recommends that it provide

provides charity (i.e., image issues, lack of the transparency regarding financial reporting) and wrestles with problems of a heavy bureaucracy, it would be advisable for UNRWA to spin off its microfinance operations into an independent legal entity.

⁶⁴ However, as noted above, ASALA recently received at \$100,000 loan from Cordaid.

⁶⁵ A model would be the USAID program established in Jordan pursuant to which donor funds are deposited as collateral in a bank to secure back-to-back loans to MFIs. For those MFIs that perform well and achieve certain performance indicators regarding profitability and growth over a specified period of time (e.g., two years), the donor fund deposit would be converted into grants to the MFIs.

⁶⁶ In addition, the guarantee fund should support bank loans to MFIs for their microlending activities.

or arrange for assistance to the MoP in drafting language on microfinance to insert into the MTDP.

Various ministries and other government officials—including in particular the PMA, MoF and the MoNE—have made clear their support for microfinance as a means of improving the economic situation of low-income Palestinians. However, there appears to be interest within the Ministry of Social Affairs (MoSA) and the MoL to develop a government-subsidized direct lending program through a new government institution, the Palestinian Fund for Employment and Social Protection. In countries throughout the world, direct government involvement in retail microlending has proven to be detrimental to the development of a healthy and sustainable microfinance sector, due to such factors as the prevalence of patronage-motivated lending decisions and extremely lax repayment discipline. Even more damaging is government lending at deeply subsidized interest rates, which poses unfair competition to the financial institutions attempting to provide microloans at sustainable market rates. CGAP recommends (i) helping the government develop a short microfinance strategy paper that will emphasize the role of government as enabler (as opposed to direct provider) of microfinance and (ii) holding a workshop on the government's role in microfinance. In addition, the donor community should engage with the MoSA and MoL to help reform the food program toward a more developmental and sustainable scheme. A smart graduation program from food assistance to microfinance could be envisioned (as discussed further below).

Lack of need for a separate “microfinance law.” There has been some discussion of the need for a separate “microfinance law.” A draft was prepared by the EU's Food Security Program that has been shared with The Microfinance Network and others. Given the various options for MFIs to engage in lending and various other activities (other than deposit taking and insurance) and plans for banks to start (or restart) microlending programs and possibly offer other microfinance services, it is not at all clear that such a law is needed or advisable, especially given (i) the regulatory burden that will be imposed on whoever may be the responsible body (ii) the general inadvisability of setting up a separate parallel financial system specifically for microfinance (as distinguished from integrating financial services for poor people into the mainstream financial system) and (iii) the current absence of financially sustainable credit-only MFIs which might be realistic candidates to “transform” into a specialized form of depository MFI. Targeted reforms to specific existing legal and regulatory constraints, such as those discussed immediately below, represent a preferable course of action.

Appropriate solution for nonprofit MFIs. CGAP recommends taking a two-pronged approach to the MFI NGOs' problems functioning under the existing NGO law.⁶⁷ First, a Cabinet decree providing for the reestablishment of the three NGO MFIs as nonprofit companies is recommended. The decree would include, among other provisions, standards regarding transparency and conflicts of interest. Second, it is recommended that language governing microlending institutions organized as nonprofit companies (and explicitly providing for the reestablishment of the three existing NGO MFIs as nonprofit companies) be introduced into the draft Companies Law.⁶⁸ Un-

⁶⁷ As noted above, these issues does not apply to PARC.

⁶⁸ The Cabinet decree is recommended as an interim measure as it appears more than likely that the Companies Law will not be finalized and passed before 2007. It is noteworthy that the Companies Law of neighboring Jordan in-

der both the proposed decree and the Companies Law provisions on nonprofit companies, it is recommended that the MoNE be the government body responsible for registering nonprofit as well as for-profit microlenders. Although CGAP is not currently in a position to recommend the appropriate body for regulating nonprofit MFIs following their registration, it appears that either the PMA or the MoNE would be a satisfactory candidate. As for the content of regulation of nonprofit MFIs, CGAP could provide advice on an appropriate transparency-driven regulatory regime for these non-depository MFIs.

Regulation of Savings and Credit Cooperatives. Although CGAP is currently not in a position to make a specific recommendation regarding the regulation of (or regulator and supervisor for) savings and credit cooperatives, this issue will become increasingly important if the cooperatives are to grow in size, both in terms of membership and total savings held. Throughout the world, there is more attention being given to the question of regulating and supervising savings and credit cooperatives and, in particular, how best to balance concern about the security of members' savings against the unique challenges that particularly smaller cooperative financial institutions present to regulators and supervisors. CGAP recommends follow-up research on this issue by an institution with experience in regulating credit unions or other similar institutional types. Particular attention should be paid to ensure that any proposed regulatory/supervisory scheme is appropriately tailored as opposed to simply imposing the prudential regulations that apply to banks and that might be overly burdensome for a small member-based organization. In addition, it will be essential that the regulator has, or is supported to develop, the capacity and expertise to adopt and enforce the prudential regulations effectively.

E. Government Policy Toward the Palestinian Poor Not Yet Ready for Microfinance

Given the state of the Palestinian economy today, it is understandable that the Palestinian Authority, and in particular the MoSA and the MoL, would be eager to engage in programming that would render speedy assistance to the poor. It is also understandable that these two ministries, in seeking to develop programs that go beyond humanitarian relief, would not see commercial microlending as the obvious next step for assistance to the poor. In fact, it is clear that many of the poor in the West Bank and Gaza would not be suitable microborrowers today.

With this understanding, CGAP recommends the following: the development of a state-of-the-art “graduation out of poverty” program for the many poor individuals and families in the West Bank and Gaza who currently depend entirely on social assistance and have no revenue stream from which they could repay microcredit.⁶⁹ In contrast to the type of government-subsidized retail microlending program under consideration by the Ministry of Social Affairs and the Ministry of Labor (which would likely be harmful both to the *long-term* interests of the microfinance sector and ultimately to those who hope to be served by the microfinance sector), such a graduation

cludes a nonprofit company legal form, and that several of the most successful Jordanian MFIs are organized as nonprofit companies.

⁶⁹ By way of example, the BRAC Income Generation for Vulnerable Group Development (IGVGD) program in Bangladesh has graduated over 2 million destitute women out of poverty and food assistance by offering vocational training and counseling, and effective access to savings and credit services.

scheme could offer the poorest Palestinians the opportunity to learn the skills and amass the capital (through learning savings discipline) necessary to become viable microborrowers.

So-called graduation schemes for the zero-income poor require careful tailoring to the specifics of the target population and the economy of the country in question, and cannot simply be replicated from one country to another without regard to these factors. For example, skills training must position successful graduates to earn an income from specific types of economic activity that are capable of being carried out in the communities where they live.

CGAP recommends as a first step that a mission be scheduled specifically to assist in conceptualizing and designing the proposed program, with due attention to: (1) identifying and quantifying the target population; (2) identifying existing and potential new sources of social assistance that could be channeled into the program; (3) determining the types of credible economic activity to which successful participants in the program might hope to graduate (and the kinds of skills presently lacking to pursue the kinds of economic activity in question); and (4) the planning of a process to identify possible implementers of the program (whether domestic actors, foreign organizations with prior experience structuring and operating successful graduation programs, or some combination of the two).

F. Demand for Financial Services

The estimates of demand for financial services among the Palestinian poor and microenterprises are impressionistic at best. The prospects for serving such demand and also for prudent allocation of donor resources will improve with better available information about the specific financial services needs of poor people and microbusinesses in the West Bank and Gaza. It is recommended that a detailed survey be undertaken to measure better the demand for loans of various types, small-balance savings products and payment/transfer services at the micro level, as well as the effectiveness of access and client satisfaction with those services currently available. However, as discussed above, this analysis also needs to take stock of the large portions of the Palestinian population who exist presently without *any* household income except from donor-funded social assistance, and who are therefore not appropriate clients for the large majority of the existing MFIs (given their exclusive focus on credit products). As observed above, these households require a well-structured graduation program if they are to become viable clients for microloans. CGAP has met with the Palestinian Central Bureau of Statistics to discuss the possibility of it conducting a survey along the lines recommended, perhaps with assistance from outside consultants experienced in assessing financial access and demand among the poor and microbusinesses.

Building on the World Bank's well-known "Doing Business Report," the World Bank and DFID have developed a new methodology to benchmark financial access worldwide. This new methodology and approach will be tested for the first time in MENA in Jordan in 2006 and could also be rolled out to assess qualitative and quantitative aspects of financial access issues.

Appendix A

Individuals Consulted

Reem H. Abboushi, Executive Director, ASALA
George T. Abed, Governor, PMA
Mohammad M. Abu-Habsa, Executive Director, Banking Supervision Department, PMA
Hasan Abu-Libdeh, Ph.D., Minister of Labour & Social Affairs, PNA
Abdul Malik Al Jaber, Chairman of Executive Board, Paltel
Salah Al-Odeh, General Manager, Ramallah Chamber of Commerce & Industry
Ashraf K. Al-Zein, Credit Manager, Arab Center for Agricultural Development (ACAD)
Mohammed Amin, Chairman of the Chamber, Ramallah Chamber of Commerce & Industry
Dr. Yousef Ashour, Director, Al Amin
Mona Assarraf, Small Loans, Bank of Palestine
Nabila Assaf, Trade Development Director, Paltrade
Claus Astrup, Senior Country Officer, The World Bank, West Bank and Gaza Country Unit
Ola Farah Mohammed Awad, General Director, Aid Management, Palestinian Central Bureau of Statistics
Hiba Qassis Barakat, Programme Management Officer, Sustainable Human Development Unit, Programme of Assistance to the Palestinian People, UNDP
Samir Barghouthi, Director, Arab Center for Agricultural Development (ACAD); Chairman, The Palestinian Network
Christian Berger, EU Representative, Office of the Special Envoy for Disengagement
Alexander Costy, Head of Coordination, Office of the United Nations Special Coordinator for the Middle East Peace Process
Ismail Daiq, General Director, PARC
Nissim Ezekiel, consultant to EWI
Nuria Medina Garcia, Assistant General Coordinator, Office of Technical Cooperation in Jerusalem, Ministerio de Auntos Exteriores y de Cooperacion, Spanish Agency for International Cooperation
Youssef Habesch, Country Officer, West Bank & Gaza Field Office, IFC
Nihaya Hammoudeh, Director of Credit and Savings Program, PARC
Jarl Hansstein, EU private sector specialist
Bettina Huber, NOVIB
Mazen S. Jadallah, Director General, International Relations Department, Ministry of Finance, Palestinian National Authority
Resi Janssen, NOVIB
Sameh Katkhuda, Operations Manager, Palestinian Fund for Employment and Social Protection
Fadwa El-Sha'r Khawajh, General Director, General Administration of NGOs, Ministry of Interior, Palestinian National Authority
Rami Khoury, Financial Advisor & Deputy Project Director, Financial Markets International, Inc.

Nick Krafft, World Bank Representative to the Office of the Special Envoy for Disengagement
Aiman Mackie, EWI
Mike Martin, Program Economist, USAID

Sufian Mshasha, Head of Sustainable Human Development Unit, Programme of Assistance to the Palestinian People, UNDP
Karim A. Nashashibi, Senior Resident Representative, West Bank and Gaza
Joseph Nesnas, Assistant General Manager, Regional Manager, Cairo Amman Bank
Alex Pollock, Director of the Microfinance and Microenterprise Programme, UNRWA
Paul Prettitore, Legal Expert, World Bank
Marta Lorenzo Rodriguez, General Coordinator, Office of Technical Cooperation in Jerusalem, Ministerio de Auntos Exteriores y de Cooperacion, Spanish Agency for International Cooperation
Luay Shabaneh, President, Palestinian Central Bureau of Statistics
Khalil Shiha, Research & Development Director, PARC
Jorge Vila, lawyer, EC consultant
Jason N. Witow, Deputy Economic Counselor, United States Embassy
Mariam Zaquot, Director, Gaza Women's Loan Fund

Appendix B

Legislation Reviewed for Report

Palestinian Laws⁷⁰

- Banks Law No. (2), 2002—unofficial translation by Samer Fares (there is no official English translation)
- Capital Market Authority Law, 2004
- Palestinian Monetary Authority Law, 1997
- Law No. 18 Concerning Amendments to Law No. 2 of 1997 Concerning the PMA, 2004 (reviewed in Arabic only by Palestinian legal counsel)
- Law of Charitable Associations and Community Organizations No. 1, 2000
- Law No. (1) on Investment Promotion in Palestine, 1998
- Amended Basic Law, 2003
- Income Tax Law, No. 17 of 2004

Laws applicable in the West Bank

Jordanian Company Law (No. 16 of 1964)

Mortgages of Immovable Properties to Secure a Debt Law (No. 26 of 1953)

The Cooperative Societies Law (No. 17 of 1957)

Laws applicable in the Gaza Strip

British Mandate Company Law (No. 22 of 1929)

⁷⁰ Unless otherwise noted, all laws were reviewed by the authors in unofficial English translation.

Appendix C

Secondary Sources

Palestinian Ministry Papers

Medium-Term Development Plan, 2005–2007, Executive Summary. Palestinian National Authority, Ministry of Planning, presented at Ad Hoc Liaison Committee meeting in Oslo, Norway, December 8, 2004.

One Year Reform Plan 2004–2005 (December 6, 2004).

Non-Government Papers

The Aix Group, “Economic Road Map: An Israeli-Palestinian Perspective on Permanent Status” (January 2004).

Chemonics International, Inc., “Analysis of the Policies, Laws, Regulations, and Supervision Practices Affecting the Environment for Microfinance in the West Bank and Gaza,” by Stephanie Charitonenko, Project Manager (submitted to Chemonics International—Initiative for Sustainable and Accessible Microfinance Industry (ISAMI) Project of USAID/ West Bank and Gaza Mission) (Feb. 2001).

DFID Country Assistance Plan for Palestinians (July 2004).

EastWest Institute, “The Erez and Gaza Industrial Estates: Catalysts for Development” (April 2005).

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European Union Food Security—Microfinance, “Draft proposal for A Microfinance Law in Palestine” (2005).

KfW Report, Overview of the Palestinian Banking System (2003).

KfW Report, “Short Term Study for SME and Microfinance in Palestine,” Judith Brandsma, author (2002).

Massar Associates, “Palestinian Informal Enterprises: Key Characteristics, Constraints to Growth, and Development Opportunities,” prepared for USAID’s ISAMI project (April 2003).

Palestinian Development Fund Paper, “Gaining an Edge: Tools for Achieving and Sustaining Real Growth in the Palestinian Private Sector” (undated draft).

World Bank Paper, “Making Microfinance Work Better in the Middle East and North Africa,” Judith Brandsma and Laurence Hart, authors (2001).

World Bank Paper, “Stagnation or Revival? Disengagement, the Palestinian Economy and the Settlements, Overview” (July 23, 2004).

World Bank publication “West Bank and Gaza Update,” Vol. 1 (November 2004).

World Bank paper “Stagnation or Revival? Israeli Disengagement and Palestinian Economic Prospects” (December 2004).

Rand Corporation, *Building a Successful Palestinian State*, Chapter 5 “Economics” (2005).

Rand Corporation, *The Arc* (2005).

Appendix D

The Development of the Palestinian Microfinance Sector and Effects of the Al Aqsa Intifada

The microfinance sector has its origins in credit programs established by various local and foreign NGOs in the West Bank and Gaza prior to and during the first Palestinian Intifada.⁷¹ These programs gave subsidized small loans (\$5,000–25,000) primarily to unemployed men and in general had low levels of repayment rates. In the early 1990s, Save the Children/US⁷² and UNRWA (United Nations Relief and Works Agency for Palestinian Refugees in the Near East) programs began to shift toward sustainable microlending.

By 2000, there were, according to a World Bank MENA microfinance survey, three “traditional” microlending and three “very small business lending” programs in the West Bank and Gaza with an aggregate of almost 14,000 clients.⁷³ The three “traditional microfinance programs” followed best practices and targeted only women. As of the end of 1999, the three programs served in the aggregate 7,264 active borrowers with a combined outstanding loan portfolio of \$2.1 million and had the deepest outreach in the region: their clients were among the poorest and the average loan balance of \$294 was 18% of the GDP and 42% of the poverty line. The programs run by FATEN (which controlled 70% of the market) and UNRWA (specifically, its guaranteed group lending program in Gaza, which controlled 26% of the market) were getting closer and closer to achieving operational sustainability. (The three “very small business lending” programs—an UNRWA microcredit program in the West Bank and the two USAID-funded West Bank programs with the Bank of Jordan and the Arab Bank—had an average outstanding loan balance of approximately \$1,000 but only 5% of the borrowers were women.)

As of 2000, all of the Palestinian MFIs, excluding the Cooperative Housing Foundation (CHF) (which made housing loans), extended loans to microbusinesses only. Other than CHF, no MFIs made consumer loans or other types of loans. However, according to the World Bank survey, the three microlending programs planned to reach 25,000 clients by 2004, in part by targeting new groups including very small businesses and consumers.

The eruption of the Al Aqsa Intifada in 2000 had severe effects on the Palestinian microfinance programs. First, the quality of all of the MFIs’ loan portfolios deteriorated very quickly.⁷⁴ Sec-

⁷¹ The operations were supported by various donors, including USAID, the European Union (EU) and the UK Office of Development Assistance (ODA). ODA later became the UK Department for International Development.

⁷² The program was spun off in early 1999 as the first independent Palestinian microfinance institution known as FATEN (Palestine for Credit and Development).

⁷³ The survey covers 16 programs involved in making “small loans,” including the six programs referred to above as well as five of the programs described as “unemployment programs” and five SME lending programs. The unemployment programs provided investment capital loans to the unemployed and to marginalized groups. Although the loans to the unemployed had an average outstanding loan balance of \$2,728 (within the range of “micro” as defined by Palestinian MFIs today), the loans were not best practice and had subsidized interest rates.

In fact, in 2000, there were other small programs—a few hundred clients each—engaged in “traditional microlending” in the West Bank and Gaza that are not included in the survey. Nonetheless, we refer to the survey’s data because (i) there are no other such studies on the microfinance sector from immediately prior to the Intifada and (ii) the excluded programs were extremely small, both in terms of portfolio size and number of clients.

⁷⁴ For instance, FATEN, which had kept its PAR>1day below 0.5% and PAR >30 days at zero prior to the Intifada experienced an increase in its PAR>1 day to 67% by November 2000 (just two months after the Intifada began). Its

ond, as a result of the shock and as neither staff nor clients could move freely from one place to another, the MFIs' ability to disburse loans was severely affected, with both the number of loans disbursed and number of active clients dropping dramatically.⁷⁵ Although some MFIs managed gradually to increase their disbursements and productivity in 2001, the reoccupation of the West Bank cities in early 2002 caused a second shock to the MFIs.⁷⁶ In general, after 2000, the operational revenues of these programs declined and those which were mainly relying on their revenues to pay their staff and expenses (such as FATEN and UNRWA) were affected the most.

In fact, the reaction to the Intifada and its effects differed from one organization to another as evidenced by the two tables below.

MFIs historical outstanding portfolio (in US\$)

Institution	PDF	ANERA	ACAD	FATEN	UNRWA	ASALA	CHF	YMCA	PARC	Total	Total without PDF
Dec-99	-		778,829	1,107,168	7,176,994					9,062,991	
Dec-00	-		992,677	1,187,169	8,555,092	836,959	4,132,830		N/A	15,704,727	
Dec-01			908,151	1,422,409	4,885,647	1,002,157	4,232,965		N/A	12,451,329	
Dec-02			779,858	549,396	3,360,554	1,086,788	3,877,720		N/A	9,654,316	
Dec-03			1,416,200	1,261,644	9,300,000	1,165,964	4,865,195		601,662	18,610,665	
Dec-04	7,015,778	690,500	2,674,936	2,383,899	5,900,499	1,230,798	8,801,215	3,309,303	1,112,223	33,119,151	26,103,373
30/9/2005	7,244,671	795,435	3,093,464	6,637,837	7,571,503	1,532,574	12,507,168	3,362,174	1,865,777	44,610,603	37,365,932

Source: the Palestinian microfinance network, it does not include data for GWLF or Al Amin. In addition, the ANERA and the YMCA were operational prior to 2004 but their historical figures were not available.

MFIs Historical average loan size (in US\$)

Institution	PDF	Anera	ACAD	FATEN	UNRWA	ASALA	CHF	YMCA	PARC	Average	avg w/o PDF
Dec-99			3,573	218	1,109					544	613
Dec-00			3,213	273	929	3,639	2,583			1,182	1,330
Dec-01			3,078	316	751	1,065	2,419			848	954
Dec-02	-		2,746	318	555	775	1,892			698	786
Dec-03	-		2,627	550	1,136	750	2,078		626	863	971
Dec-04	10,679	2,484	2,705	718	592	655	2,963	3,087	973	2,762	1,772
30/9/2005	10,454	2,634	2,237	1,493	646	741	3,346	2,740	1,853	2,905	1,961

Source: the Palestinian microfinance network, it does not include data from GWLF or Al Amin. In addition, the ANERA and the YMCA were operational prior to 2004 but their historical figures were not available

In general, the reactions can be summarized as follows:

Commercial Banks: Although the banks had experienced a few years of good performance and planned to expand the microcredit products, they quickly closed down the microfinance programs as a result of the delinquency and arrears problems they began to face in the Intifada.

PAR>30 days reached 28% in January 2001. The situation was worse for those programs which did not have a good quality portfolio before the Intifada.

⁷⁵ For example, prior to the Intifada, FATEN disbursed an average of 1,100 loans per month. By October 2000, this figure had decreased to below 80. FATEN's active clients decreased from 6,222 at the end of September 2000 to fewer than 4,000 active clients in March 2001.

⁷⁶ Toward the end of 2001, FATEN had increased its number of active clients to approximately 5,500. However, the number declined to its lowest of 1,500 by the end of 2002. During the last ten months of 2002, FATEN disbursed fewer than 150 loans per month.

The Pre-Intifada Market Leaders (FATEN and UNRWA): FATEN and UNRWA had opposite experiences. FATEN introduced more of the upper end of microloans and small loans and requested more guarantees and other collateral. At year-end 1999, FATEN had approximately 5,000 active clients with a US\$1.1 million portfolio (average loan balance: \$218). Five years later, FATEN had 3,319 clients with an outstanding loan portfolio of \$2,383,889, resulting in an average loan balance of \$718. By September 2005, its average loan balance had increased to \$1,493 and its portfolio size had tripled.⁷⁷

In contrast, during the five years since the beginning of the Intifada, UNRWA reduced the average loan size of its small lending activities (which in fact became microlending programs) and increased its number of clients, including through the commencement of operations in Syria and Jordan. Consequently, it has become the largest MFI in the West Bank and Gaza, controlling 43% of the market. As of September 2005, UNRWA had over 11,700 clients in the West Bank and Gaza out of a total of approximately 27,000 active micro and small borrowers (the overwhelming majority being micro), with a loan portfolio of US\$7.6 million. However, it has continued to suffer from portfolio quality issues and a high number of written-off loans.⁷⁸

Other MFIs: Arab Center for Agricultural Development (ACAD), Palestinian Businesswomen's Association (ASALA) and (PARC) each has significantly increased the number of active clients from its pre-Intifada level of 100–300.⁷⁹ Today ASALA has over 2,000 borrowers, ACAD has almost 1,400 and PARC has just over 1,000. In the case of ACAD and ASALA, this increase was accomplished through the introduction of micro products after years of only doing small loans.⁸⁰ PARC on the other hand, took a completely different approach and began establishing savings and credit cooperatives during the Intifada. PARC cooperatives have not only become collectively one of the biggest microlenders, but they are the only MFI to collect voluntary savings, reaching more than 5,600 members (which makes them the second largest MFI after UNRWA, when measured by the number of clients overall).

CHF decided to extend its activities to the West Bank after having them limited to the Gaza Strip for years. They also decided to reduce their loan size and to introduce business loans. American Near East Refugee Aid (ANERA) and Gaza Women's Loan Fund (GWLF) continued their operations on the same basis as pre-Intifada: with limited outreach and significantly subsidized.

⁷⁷ In the first nine months of 2005, FATEN experienced a significant expansion in its portfolio. As of end September 2005, it had almost 4,500 active clients with an aggregate loan portfolio of US\$6.64 million. 66% of the clients were micro with an average loan balance below US\$500 (<20% of the portfolio) and 28% had an average loan balance below US\$5,000 (50% of the portfolio). This rapid expansion is a result of a 2005 grant of \$5 million from USAID. Several MFIs have complained that if they had additional funding, they would also expand their portfolios. The same MFIs have complained that the grant funds have in fact caused FATEN to shift to bigger loans.

⁷⁸ Between 2001 and 2005, UNRWA wrote off loans with an aggregate principal amount of \$4.75 million, collecting from those loans approximately \$2.3 million.

⁷⁹ The first PARC-supported cooperatives were established in 2003; however, PARC had already been engaged in microlending as part of the programs of its women's clubs. The comparison is therefore between PARC's pre-Intifada clients and PARC cooperatives' clients today.

⁸⁰ In fact, ASALA's program changed primarily as a result of the 2001 transfer by Catholic Relief Services of its group lending program (initiated in the refugee camps in Gaza) to ASALA.

Appendix E
MFI Outreach Indicators⁸¹

	ACAD[1]	ANERA	ASALA	CHF	FATEN	GWLF	PARC	PBC/ PDF	UNRWA	YMCA	Total	Total w/o PDF
Loans												
No. of active borrowers Sept 05	1,383	302	2,059	3,738	4,446	330	1,007	693	11,715	1,227	26,900	26,207
Outstanding balance (US\$) Sept 05	3,093,464	795,435	1,532,574	12,507,168	6,637,837	n/a	1,865,777	7,244,671	7,571,503	3,264,174	44,512,603	37,267,932
Avg. outstanding balance (US\$) Sept 05	2,237	2,634	744	3,346	1,493	n/a	1,853	10,454	646	2,740	2,905	1,962
No. of loans disbursed (2004)	684		2,059	1,120	5,873		1,205		14,852	192	25,985	25,985
Value of loans disbursed (2004)	2,111,700		1,300,600	5,309,000	4,356,010		1,281,996		12,590,366	1,094,950	28,044,622	28,044,622
Savings												
No. voluntary savers-Sep 05	1,560						5,653				7,213	7,213
Total voluntary savings- Sep 05	384,767						1,471,524				1,856,291	1,856,291
No. compulsory savers- Sep 05			1,655		900						2,555	2,555
No. staff	14	9	22	33	63	n/a	n/a	40	185	28	394	354
No. loan officers	9	4	15	9	34	n/a	n/a	17	81	10	179	162
No. of offices	8		8	8	15		15		11	7	72	72

[1] ACAD's figures do not include the farmers' cooperatives that are supported by ACAD and that have savings and credit programs except for the figures on voluntary savings and the number of savers.

⁸¹ This chart does not include the data for Al Amin. In addition, although PBC/PDF is included in the chart, it engages in SME lending (not microlending).

Appendix F
Microfinance in the Arab World (Benchmarks)—MIX 2003 Report

OUTREACH INDICATORS	All MFIs	Arab	Arab FSS	Arab Non FSS	Arab Large Outreach	Arab Medium Outreach	Arab Mature	Arab Young
Number of Active Borrowers	47,688	25,561	37,559	13,264	77,747	13,809	20,372	31,111
Percent of Women Borrowers	60.2%	78.2	81.3%	74.2%	68.2%	79.6%	100.0%	75.3%
Gross Loan Portfolio	19.214.3776	5.884.795	8.275.951	3.493.60	16.035.898	2.763.682	5.054.203	6.899.819
Average Loan Balance per Borrowers	689	348	338	359	224	215	341	299
Average Loan Balance per Borrowers/GNI per Capita	74.7%	19.9%	20.7%	19.1%	16.8%	12.5%	25.8%	15.4%
FINANCIAL STRUCTURE								
Capital/Asset Ratio	44.1%	74.7%	74.4%	75.1%	71.3%	76.8%	89.4%	71.3%
Commercial Funding Liabilities Ratio	63.2%	17.6%	12.6%	22.6%	25.0%	36.6%	23.3%	18.4%
Debt/Equity Ratio	2.2	0.5	0.4	0.6	0.4	0.3	0.1	0.6
Deposits to Loans	43.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Deposits to Total Assets	19.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Gross Loan Portfolio/Total Assets	70.5%	67.4%	80.9%	53.8%	64.5%	68.1%	50.7%	68.6%
PROFITABILITY/ SUSTAINABILITY								
Return on Assets	-0.8%	2.1%	8.1%	-3.9%	5.0%	4.1%	1.1%	1.6%
Return on Equity	5.9%	2.8%	10.7%	-5.1%	7.8%	4.7%	1.7%	2.2%
Operational Self Sufficiency	122.8%	118%	142.3%	94.6%	127.1%	114.5%	98.8%	105.9%
Financial Self-Sufficiency	107.7%	106%	133.2%	79.7%	127.1%	114.5%	98.8%	105.9%

Source: MIXmarket, www.mixmarket.org

Microfinance in the Arab World (Benchmarks)—MIX 2003 Report (follow)

EXPENSE	All MFIs	Arab	Arab FSS	Arab Non FSS	Arab Large Outreach	Arab Medium Outreach	Arab Mature	Arab Young
Total Expense Ratio	29.4%	28.4%	24.9%	24.8%	16.5%	26.3%	17.3%	26.6%
Financial Expense Ratio	7.1%	2.9%	2.1%	3.7%	3.1%	3.0%	4.5%	2.7%
Loan Loss Provision Expense Ratio	2.3%	-0.2%	0.3%	-0.8%	0.7%	0.2%	-2.0%	0.1%
Operation Expense Ratio	20.0%	22.1%	22.5%	21.9%	12.6%	23.1%	14.8%	23.8%
Personnel Expense Ratio	11.0%	13.8%	14.2%	13.5%	8.3%	13.0%	10.7%	14.7%
Administrative Expense Ratio	9.1%	8.3%	8.3%	8.4%	4.3%	10.1%	4.1%	9.0%
EFFICIENCY								
Operating Expense/Loan portfolio	33.2%	39.9%	29.5%	48.3%	20.4%	32.0%	31.7%	42.4%
Personnel Expense/Loan portfolio	17.9%	26.2%	18.6%	23.3%	13.3%	18.3%	23.4%	27.6%
Average Salary/GNI per Capita	748.4%	420%	443.0%	398.9%	405.3%	275.3%	506.6%	396.9%
Cost per Borrower	158	121	85	157	43	58	135	111
PRODUCTIVITY								
Borrowers per Staff Member	136	138	168	107	190	127	88	153
PORTFOLIO QUALITY								
Portfolio at Risk>30 Days	5.2%	2.2%	0.4%	4.0%	2.6%	0.5%	9.3%	0.5%
Portfolio at Risk>90 Days	2.8%	1.5%	0.4%	2.6%	2.5%	0.3%	6.0%	0.3%
Loan Loss Rate	2.5%	2.6%	0.5%	4.7%	2.3%	0.3%	9.6%	1.2%
Risk Coverage	278.7%	368.3%	282.2%	489.6%	203.9%	424.8%	399.4%	420.8%

Appendix G
Recommended timing of recommendations

	0–6 months	7–12 months	Up to 36 months
A. Capacity Building:			
1. MFIs	<ul style="list-style-type: none"> • Training courses for microfinance managers (November and February)—CGAP/SANABEL • Strategic business plan (CGAP funded) • Rating of select MFIs 	<ul style="list-style-type: none"> • Continuation of assistance listed in 0–6 months • Identification of a local training partner/PMA 	<ul style="list-style-type: none"> • Continuation of TA
2. Commercial Banks	<ul style="list-style-type: none"> • Awareness-building workshops (in association with PMA) • Identification of 1 or 2 interested banks 	<ul style="list-style-type: none"> • Continuation of awareness-building • TA for selected banks 	
3. Rafah Bank	<ul style="list-style-type: none"> • Strategic advice and international TA (provided by IFC) 	<ul style="list-style-type: none"> • TA (funded by IFC) 	<ul style="list-style-type: none"> • TA (funded by IFC)
4. Microfinance Network	<ul style="list-style-type: none"> • Request for proposal for local network 	<ul style="list-style-type: none"> • Performance based grant agreement 	<ul style="list-style-type: none"> •
5. Cooperatives	<ul style="list-style-type: none"> • Project identification 	<ul style="list-style-type: none"> • Project preparation 	<ul style="list-style-type: none"> • Project implementation
B. Transparency/ Accountability	<ul style="list-style-type: none"> • Assessment of need for upgrading of MFIs’ MIS • TA re business reporting standards and MIS evaluation support (CGAP) • Financial reporting training (as part of financial analysis training course) 	<ul style="list-style-type: none"> • Auditor training/list of qualified auditors • Follow-up re reporting • Reporting compulsory for MFIs receiving grants 	<ul style="list-style-type: none"> • Network or other entity provides yearly benchmark on performance of MFIs (SANABEL/MIX)

	0–6 months	7–12 months	Up to 36 months
C. Funding of Microfinance Service Providers	<ul style="list-style-type: none"> • Development of program supporting bank lending to MFIs (involving guarantee and grant) 	<ul style="list-style-type: none"> • Performance-based grants for MFIs with business plan • Start-up of banking lending program 	<ul style="list-style-type: none"> • Start-up of guarantee fund(s)
D. Regulatory Framework	<ul style="list-style-type: none"> • Draft language on microfinance support scheme for MoP's MTDP • Short government microfinance strategy note • Initial steps for "conversion" of NGO MFIs into nonprofit companies (present problem and framework for solution) • Follow-up research on issue of regulation of savings and credit cooperatives • 	<ul style="list-style-type: none"> • Workshop on government's role in microfinance • If initial steps for "conversion" are approved, then draft relevant legislation. Upon passage, effect conversions. 	
E. Graduation from welfare program to microfinance	<ul style="list-style-type: none"> • Mission for Project identification and design 	<ul style="list-style-type: none"> • Project preparation and implementation 	
F. Demand Survey		<ul style="list-style-type: none"> • Conduct survey of demand for microfinance services 	<ul style="list-style-type: none"> • Survey dissemination