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ESAF Program
Expanded and Sustained Access to Financial Services

ESAF BRIEF: Innovation, Best Practices & Knowledge Generation

Developing a National Policy Framework for the Microfinance Sector in Palestine

Background

Access to financial services for poor and low-income communities is critical for economic development in any context. This is particularly important in the West Bank and Gaza, where an unstable political environment frequently leads to market disruptions and has fostered a local economy that is heavily influenced by external forces, such as Israeli trade restrictions and dependency on international aid. Sustained access to financial services, especially for poor and low-income communities, helps increase household income and economic security, builds individual assets, reduces vulnerability, creates demand for other goods and services (such as healthcare and education), and stimulates local economies.

The growth of microfinance services in Palestine has suffered in the past due in part to poor donor coordination and lack of consensus on the objectives and structure of the microfinance industry. Many donors operating in Palestine have seen microfinance as just another relief activity and funded it accordingly, while others have looked to it as a sustainable industry that should contribute to the development of an inclusive financial system and long-term economic growth. Therefore, donor coordination activities have been piecemeal due to the differing approaches and the absence of strong incentives to bring the different donors together.

Cover design: Direct Way

The Microfinance Policy Framework for Palestine, which lays out guiding principles for industry stakeholders as well as strategies for further strengthening the industry at every level, was finalized and disseminated in January 2010.

This lack of consensus extended to the regulators, where three different regulatory bodies had supervisory responsibilities over the sector.

In addition, microfinance institutions (MFIs) operating in Palestine are generally small, with the top three serving 90% of the market. Moreover, even MFIs are not primarily serving the poor. ESAF research found that only 12% of MFI clients in the West Bank are below the national poverty line (vs. 47% of the West Bank population overall, on income measures). In terms of MFI efficiency, the average cost per loan in Palestine is US$274, compared to US$66 for the region, and the current loan officer productivity rate of 136 clients per loan officer is half the regional and global norm. In addition, generally speaking, the microfinance industry is still very reliant on donor

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The Expanded and Sustained Access to Financial Services (ESAF) program is a three-year US$36 million program, funded by USAID, and designed to build a more inclusive financial sector in the West Bank and Gaza, for Palestinian households and enterprises. ESAF is implemented by AED in partnership with The William Davidson Institute, ShoreBank International, CHF International, CARE and Save the Children, and is an Associate Award under the FIELD-Support Leader with Associates, which is managed by AED. www.microlinks.org/field.

grants
for funding. In fact, only 10% of all capital in the Palestinian market is being financed through borrowing, as compared to 79% for the region.

Towards a Microfinance Policy

In 2008, with encouragement from MFIs and some donors, the Palestine Monetary Authority (PMA), the regulator of commercial banks, decided to bring microfinance under its purview in order to both professionalize the industry and promote its balanced growth. This decision by this significant player catalyzed donor coordination. The United States Agency for International Development (USAID), with the PMA, seized on the opportunity by creating the Micro and Small Finance Task Force under the Ministry of Planning's donor coordination framework. In April 2009, under the direction of the PMA, the Task Force launched a consultative and participatory process to develop a common understanding and vision for the role of microfinance in the Palestinian financial sector's development. With direct engagement from both local and international stakeholders, including up to fifteen donor agencies, and with technical assistance from USAID's Expanded and Sustained Access to Financial Services (ESAF) program, the Task Force led an iterative process that allowed stakeholders to debate and explore diverging approaches to develop a shared Microfinance Policy Framework.

Along a parallel track, ESAF continued to provide support for the development of the PMA's Microfinance Unit. This included technical assistance from ESAF partner the IRIS Center at the University

Photo by Morocco Central Bank

In 2009, ESAF led a delegation of PMA staff on an exposure trip to Morocco's Central Bank to learn about regional best practices in microfinance supervision from senior representatives, including the deputy Governor.

of Maryland and an exposure trip for staff of the PMA's Banking Supervision Directorate to Morocco, where the Central Bank supervises microfinance. The trip introduced them to different models of regulation and, importantly, increased their comfort with the concept of a separate regulatory framework for non-bank financial institutions. As a more knowledgeable player, the PMA was able to engage more actively in the debate over the Framework and agree to concepts that might have seemed revolutionary in the past, such as giving MFIs the opportunity to mobilize savings once they reached certain benchmarks.

In the resulting Microfinance Policy Framework for Palestine, the Task Force and the PMA identified some of the key priorities for a national policy that

The Microfinance Industry in Palestine

Roughly 80% of private sector entities in Palestine can be categorized as MSEs, yet 60% of these do not have access to banking services. Low rates of savings (4.1% of GDP compared to 32.5% in the region and 12.4% in sub-Saharan Africa) mean that a large portion of potential investment capital that can be put to use to spur economic growth is left untapped. With 55% of the population living below the poverty line and 79% of all jobs created by the MSE sector, demand for financing at this level is substantial in spite of a difficult operating environment.

In addition, banks, which have adequate liquidity, are extremely conservative in their lending practice – especially when dealing with smaller enterprises – due in part to the uncertain political situation and an insufficient regulatory and enabling environment, which makes seizure of collateral time-consuming and costly. There are only a handful of specialized MFIs and a number of multi-service NGOs that are specifically targeting MSEs, however, market penetration is very low, and the majority of MFIs are focused on urban areas, leaving rural populations with very little access to finance for agriculture-related activities. Poverty outreach is also low, as only 12% of MFI clients in the West Bank are under the national poverty line (vs. 47% of the West Bank population overall, as measured by income).

will support the growth of a more inclusive and financially sustainable microfinance industry in Palestine. Three basic principles that will drive the future development of the microfinance industry are:

1. **Be market-oriented.** Reforms should focus on demand and not lead to market distortions, such as by targeting beneficiaries, subsidizing loan programs, capping interest rates, and applying debt forgiveness schemes, which might have negative impacts on the sector and could discourage the entry of private and quasi-private capital.

2. **Adapt the legal and regulatory framework** to be more supportive of an inclusive financial sector that provides both credit and savings mobilization. This includes ensuring appropriate capital adequacy requirements, maximizing shareholding participation, and creating distinct regulatory and supervisory requirements and legal institutional forms for different categories of non-bank financial institutions.

3. **Maintain a clear distinction between welfare schemes and microfinance operations**, with welfare being restricted to poor households that are economically inactive and unable to benefit from access to credit.

Towards A Mature Microfinance Industry

The PMA and its stakeholders have identified the following key characteristics of a mature microfinance industry and have designed a framework to help the Palestinian microfinance sector become stronger in these key areas:

- An enabling policy environment
- A competitive capital market
- A range of financial service providers
- Transparency, accountability, and a supportive infrastructure
- Existence of non-financial services to MSEs, such as business development services

To ensure that these principles remain at the core of the Framework, the Task Force identified several areas where local stakeholders need to enhance their internal structures and services. For instance, on the demand side, consumers have low levels of financial literacy. This is due in part to a combination of the lack of a credit culture and a general distrust of banks and interest-bearing financing, as well as limited consumer protection mechanisms that leave medium and small enterprises (MSEs) vulnerable to abusive collection practices, breaches in confidentiality, and inadequate dispute resolution mechanisms.

A pervasive challenge remains the restrictive operating environment of occupation, which puts severe limits on market development, labor and commodities movement, capital flows, and productivity in general. The private sector needs to focus on strengthening internal processes to become more financially sustainable and less reliant on the Israeli market. Therefore, part of the Policy Framework includes a focus on building the capacity of MFIs in terms of managerial, technical, and financial skills, including: business planning; asset, risk, and liquidity management; internal controls; capital mobilization; social performance measures; and client protection policies. These capacities will help MFIs professionalize their operations and ensure they comply with new PMA regulations based on the pending draft banking law, which are designed to foster a more inclusive financial sector.

An Integrated Approach

Leveraging industry best practices, the Framework sets forth several key strategies to address the regulatory, industry, retail, and MSE levels of the financial market.

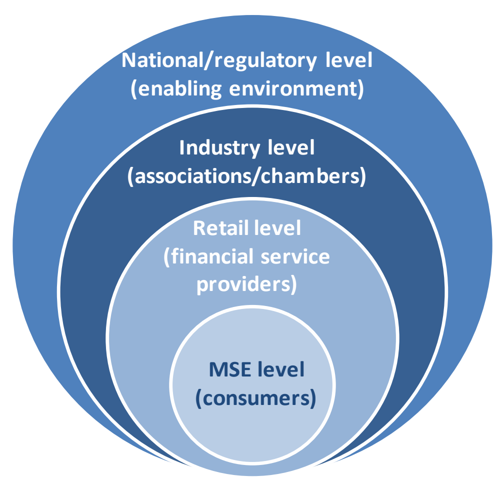

Figure: Levels of the National Policy Framework

- At the **National/Regulatory level**, the regulations that will be drafted around the microfinance sector will address gaps in the legal environment that currently limit the growth of NGOs into fully licensed deposit-taking MFIs. Top priorities include developing a standard categorization system for MFIs with oversight, regulation, and supervision requirements and continuing support for the PMA's specialized Microfinance Unit to act as a monitoring, coordinating, and supervisory authority for the industry.

- At the **Industry level**, attention needs to be paid to further developing the national microfinance network, Sharakeh, to act as more of a storehouse of knowledge for the sector, facilitating information exchange and promoting industry standards and development among its members. In particular, this includes identifying and developing demand-driven services for its members, such as for cost recovery and investment readiness. In addition, the Framework calls for developing voluntary self-reporting systems among members to enhance industry transparency. Further, the Framework recognizes that MFIs can benefit from cost-efficient, demand-oriented training programs, which means upgrading private sector training providers, such as the Palestine Institute for Financial and Banking Studies (PIFBS). Lastly, there is a strong need for greater research and development aimed at designing, introducing, and promoting new technologies, such as mobile banking, to enhance efficiencies in an unstable but emerging market.
- At the **Retail level**, as mentioned above, there is a need for technical assistance targeting professionalization of MFIs to make them better compliant with new PMA regulations and more able to diversify their funding base. As above, the Framework also calls for supporting MFIs to create innovative new loan products (i.e., mortgage, agriculture, insurance, Islamic lending) and mitigate the risks associated with increasing their reach into rural and low-income areas. This might include the development of an incentive plan for smaller MFIs, but also for larger commercial banks to downscale their services. Lastly, encouraging MFIs to increase transparency in the sector by extending credit bureau participation to a broader range of MFIs will be key.
- At the **MSE level**, interventions need to increase and enhance the demand for MFI services and might include addressing low levels of financial literacy; supporting institutions that provide business development services and capacity building in operational, managerial, or technical skills; and strengthening cooperation among the public, private, and civil society stakeholders to optimize the employment of innovations and improved quality of products and services.

In January 2010, the Microfinance Policy Framework for Palestine was endorsed by a range of stake-holders who committed to partner with the PMA according to internationally accepted best practices in the promotion of an inclusive financial sector. Since then, the Task Force has developed a matrix of current and planned donor activities and formed a working group to consider how to best transition MFIs to commercial sources of funding. The Task Force's next step is to develop an action plan that will insure gaps identified in the Framework are addressed and donors do not duplicate efforts.

Conclusion and Lessons Learned

National microfinance policies have been developed in many countries and with various results, with some driving the development of the sector and others being quickly forgotten. While the impact of the Framework for Palestine has yet to be felt, there are encouraging signs. The Framework has already helped to unify expectations for the sector among donors and provided a clear development path for individual MFIs that was lacking. The PMA's backing has also improved commercial bank trust in MFIs, leading to the first wholesale loan to a MFI from a local bank. If the PMA continues in this leadership role, there is promise that the sector will develop more rapidly in the future.

As in other countries, the successful development of the Microfinance Policy Framework for Palestine can be attributed to the presence of a strong local champion for the microfinance sector, the PMA in this case, with access to assistance from a partner with the expertise and resources to facilitate capacity building and generate productive discussions with stakeholders. The presence of both elements will be necessary for continuing success in the future.