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Financing Development in Palestine through Microfinance Institutions and Development Banks: Options and Challenges

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Foreword

This study formed one of MAS's priority research topics for 2021, examining options for - and challenges in – the financing of development in Palestine, considering different mechanisms and institutions. In this context, microfinance institutions play a major role, providing microfinance services to poor, low-income and marginalized groups that cannot access financing provided by the mainstream banking sector. In 2021, the Palestinian government announced the establishment of the Independence Bank for Investment and Development. The study addresses the problems that accompanied this announcement, in light of the lack of clarity on its objectives and its developmental role, combined with the lack of a comprehensive vision for development and the national fight against poverty. With this in mind, the study proposes a set of appropriate interventions and policies for various relevant authorities, including the Independence Bank, in order to enhance development finance and the access capabilities of poor/marginalized groups. The study also outlines tools to regulate the relationship between the Independence Bank - as a governmental tool for investment and development - and microfinance institutions.

The study concludes that there are great opportunities for the growth of the microfinance sector. However, the removal of challenges faced by the sector is essential, to enable it to play a greater role in promoting comprehensive and sustainable development in Palestine. This requires adopting appropriate measures and policies by various relevant authorities. The study recommends adopting a comprehensive development concept by microfinance institutions that is relevant to the Palestinian context; directing efforts to establish guarantee funds/programs for financing provided by microfinance institutions; developing and activating complementarity in the microfinance system; securing temporary financing lines for microfinance institutions, allowing them to withstand emergencies arising from Israeli policies hostile to the Palestinian economy.

As for the Independence Bank, certain conditions must be met for this initiative to succeed, as informed by the experiences of other countries in establishing and operating public banks. This includes developing the legal environment for the Bank, such that it is protected (as much as possible) from unstable economic and political conditions in the Palestinian territories. Moreover, the Bank's mandate (mission) in the economic and societal sectors must be defined in a clear and phased manner and must be complementary to the existing institutional environment. The Bank needs to be able to answer various questions on its mandate and the nature of its work. Palestine should avoid the failures experienced by other public banks, both regionally and globally, while stimulating conditions for the success of public investment at a level of risk that cannot be met by private investment. Hence, it is recommended that the Bank refrains from providing financial services, and that it prioritizes large development projects that the private sector is reluctant to – or cannot – implement solely.

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Raja Khalidi
Director General

Executive Summary

Microfinance institutions (MFIs) began working in Palestine in the 1980s, in the form of non-governmental organizations (NGOs), in order to fill the large funding gap caused by the Israeli occupation authorities' closure of banks in the West Bank and Gaza Strip. At that time, MFIs played an important role in fostering production and employment, fighting poverty and stimulating development. Most of them received support from local and international NGOs, in order to provide microfinance services to poor and marginalized groups.

Early in 2021, the Palestinian Government issued Law No.5 of 2021, establishing a governmental development bank, named the *Independence Bank for Investment and Development.* Financed by government capital, it works to promote development and fight poverty, especially in light of the social and economic challenges caused by the Corona pandemic; and large gaps in development financing in Palestine. Studies emphasize the importance of such a bank in promoting development. However, a number of conditions need to be fulfilled, most notably the adoption of a clear mandate which allows for an evaluation of the extent to which objectives have been realized. Moreover, the establishment of such a bank will have repercussions on the developmental role of MFIs, and on overall efforts for stimulating development, fighting poverty and reducing levels of marginalization.

This research paper aims to identify options for, and challenges in, financing development in Palestine, in which MFIs play a major role. MFIs provide microfinance to poor, low-income and marginalized groups who would not otherwise be able to access finance from the mainstream banking sector. This is of special concern given the establishment of the *Independence Bank for Investment and Development*, and the problematic aspects of the Law of the lack of clarity of the objectives and developmental role entrusted to the Bank, as well as its incoherent vision for development and fighting poverty at the national level.

In addition to a literature review covering both Arab and international sources, combined with a review of relevant laws and decisions in Palestine effective in 2021, the researchers collected and analyzed data from primary and secondary sources. The study methodology included, mainly, in-depth interviews with a sample of MFIs in Palestine, and from other relevant parties (official entities, field practitioners in development financing, private sector representatives and development experts), in order to study and analyze the reality of microfinance in Palestine, and the nature of the developmental role that it plays.

Experiences of MFIs and development banks across the globe

Profit-making is one of the main tools utilized by MFIs to maintain their financial sustainability. For a long time, experts believed that establishing a commercial market for microfinance is the most appropriate way to expand microfinance services around the world. This trend had negative repercussions on MFIs' ability to achieve their developmental goals across many parts of the world, due to intense competition between them for market share, as well as the rapid transformation of some of them into quasi-commercial banks (driven by profit). This may be the most prominent reason for the increasing spread of the phenomenon of mission drift, in which specialized financial institutions move away from achieving their social/developmental goals and increasingly focus on financial performance/profits.

Across many countries, governments intervened by setting controls on MFIs, to avoid their transformation into commercial banks concerned only with profits and financial sustainability, at the expense of their social and developmental goals. The aim was to maintain a balance between MFIs' financial and social performance, and to limit the phenomenon of deviation from their initial developmental goals. Primarily, government provides guarantees for MFIs' loans, in addition to incentives for social and development performance.

Globally, the attempts of governments to participate directly in the microfinance sector have proven unsuccessful in many countries, as they tend to crowd-out the private sector and MFIs, greatly affecting the sustainability of microfinance programs. Government competition with

MFIs (through direct investments in the financing market, or by setting inappropriate ceilings on interest rates for microfinance loans) is one of the most prominent negative factors that may cause harm to non-governmental or private MFIs, narrowing the scope of services that they can provide and causing them to exit the market.

Despite failures in the experiences of development banks in a number of countries (Nepal, Mexico, Colombia, Venezuela) during the last three decades of the 20th century, and the closure or privatization of many of them, they remain an effective tool used by many countries to create enabling conditions for success, by correcting failures in the development finance sector. Moreover, it is possible for governments to use development banks as an effective mechanism for building a policy framework, covering organizational/administrative structures and sustainable financial models for such banks. This enables them to achieve their developmental goals independently of government.

Legal framework for microfinance in Palestine

During the last decade, the Palestinian National Authority has developed the legal framework governing this sector, by issuing of a number of laws and instructions, and by the direct regulation/supervision of the Palestine Monetary Authority (PMA) over the work of MFIs. In this regard, Law No. 6 of 2008 can be considered an amendment to the Companies Law of 1964, while Resolution No. 3 of 2010 regarding systems at non-profit companies are among the first laws adopted that are directly related to the work of MFIs. Additionally, Banking Law No. 9 of 2010 assigned the PMA the power to grant operating licenses to specialized lending institutions, and to monitor and supervise them. PMA is the "only body authorized to formulate and set monetary policy and to supervise its implementation". Subsequently, Presidential Resolution No.132 of 2011, regarding the licensing and supervision of specialized lending institutions, strengthens and elaborates on Law No. 9 of 2010, especially concerning the regulation of the work of specialized lending institutions.

PMA is keen to organize the supervisory relationship in a participatory approach, and to provide a sound regulatory environment based on best practices, while taking into account the specificities of the Palestinian context. PMA works to prepare sector-wide strategies on an ongoing basis, and in partnership with financing institutions, helping them to achieve their goals and fulfill the tasks assigned to them.

Concerning the licensing of lending institutions and their transformation into companies (2011-13), PMA focused on laying the foundations for this sector. It applied rules of governance in accordance with international best practices, defining responsibilities and powers of boards of directors and executive management, strengthening internal/risk control systems, as well as regulating disclosure, transparency and accountability mechanisms.

During field research and in-depth interviews (conducted as part of this study), numerous parties pointed to the positive developmental role and relevance of MFIs, especially in light of severe economic and social challenges faced by marginalized groups and regions, and repercussions on the expected growth of demand for such financing. At the same time, these parties emphasized the deviation of some MFIs - during the past decade - from the mission and development goals for which they were established. Increasingly, they have come to rely on commercial methods, despite the numerous laws and regulations adopted by the PMA to regulate their work.

Based on these new laws and regulations, MFIs have been transformed from non-governmental and non-profit associations/organizations (most of which receive direct support from international financing and development institutions) to (for-profit or non-profit) companies. This new reality created a new administrative and financial environment for these institutions. MFIs are now using new mechanisms for work processes and accounts' management, based on market and profit considerations. They are now in the position to extend finance at market rates, according to the categories that they target and associated risks. They can also further grow their investment portfolios by borrowing from commercial banks, thus expanding their business volumes.

Competition between companies working in microfinance, and their pursuit of profits, has prompted them to diversify their product offerings and credit portfolios, to include both the developmental and non-developmental sectors. MFIs are now providing a variety of financial services for non-developmental purposes, such as consumer loans and housing improvement (purchasing, building completion, finishing, or interior repairs). Under the pressure of competition, MFIs still managed to achieve financial sustainability. The objectives of a number of them deviated from focusing on micro/small-sized projects targeting small-scale producers, marginalized groups and the poorest, to providing larger loans targeting the industrial sector, and on occasion entering into direct competition with commercial banks.

Challenges facing MFIs

The Israeli occupation and its policies are not the only challenges facing development institutions in Palestine. There are many other challenges that limit their ability to implement their development goals, based mainly on improving the standard of living of small business owners and low-income persons, as well as reducing poverty and unemployment.

First, there is a lack of a comprehensive and unified concept of developmental finance among MFIs. Some believe that promoting development requires owning a large financing portfolio, through which they can expand their lending cycle. Others do not see a problem with consumer loans. Others target medium-sized projects, or non-marginalized groups, that do not qualify for traditional, commercial financing. Second, an integrated and unified system for microfinance that brings together all related parties is absent. Therefore, there are no efforts at coordination between players, in promoting development and ensuring comprehensive coverage of all marginalized groups/regions. Third, the absence of loan guarantees for the owners of small-size projects does not encourage banks and other financial institutions to increase the volume of credit granted to enterprise. Finally, competition between MFIs may lead to negative results for the structure of the microfinance market, characterized by the forced exit of some small players, as happened in numerous developing countries during the 1980s, particularly in Latin America. There are concerns that MFIs will move away from development and social financing, towards the commercial financing of consumption and services, in order to underwrite their financial sustainability.

Decision to establish the *Independence Bank for Investment and Development* and options for the Bank's relationship with the microfinance sector

The Palestinian government has experimented with microfinance, by establishing some institutions specialized in lending, with specific mandates. The Palestinian Agricultural Credit Institution (PACI) was established in 2015 to specialize in "providing loans to agricultural projects, whether for individual farmers or companies operating in the agricultural sector" that are unable to obtain financing from the traditional commercial sector (Decision No.8 of 2015 establishing the Palestinian Agricultural Credit Institution). It is not possible to evaluate PACI's experience at present, given the short period of time in which it has operated and the lack of resources that were made available to it. However, PACI is clear evidence of weak governmental commitment towards the agricultural sector on the one hand, and towards the microfinance sector on the other hand. Despite the decision to establish PACI six years ago, the government did not allocate it the financial resources that it needed to contribute to development efforts in the agricultural sector. Its funding situation is similar to other government institutions (the Palestinian Disaster Risk Reduction and Insurance Fund, PADRRIF, and the Palestinian Employment and Social Protection Fund). Both are well-designed and established with a relevant and clear mandate but have been left without the necessary public resources to take effective action in the development field.

International experience in this context shows that there are multiple factors - related to different issues - that influence the prospects of success for governmental development banks in achieving their goals. Here, we review these factors and issues, shedding some light on their availability (or otherwise) in the Palestinian context.

1. *A stable macroeconomic and political environment*. It can be discerned that the failure of governmental development banks is linked to clear cases of economic or political instability, and an inappropriate legislative or investment environment. Some banks failed as a result of the spread of financial and administrative corruption in the public sector, which was entrusted with their

management. There is no doubt that the issue of “business environment stability” is lacking in the Palestinian context, which does not bode well for the *Independence Bank’s* chances of success. The lack of necessary financial/administrative control in the government sector may undermine the chances of success of the *Independence Bank* experiment, especially with regard to employment, promotions, transparency, accountability, as well as governmental interference in the decisions and activities of governing bodies. On the other hand, global experience indicates that management of financial institutions is often characterized as inefficient and ineffective. These risks can be mitigated, and such issues addressed, by subjecting the Bank to PMA’s regulations and procedures, which have proven effective in managing the Palestinian banking sector.

2. *Clear mandate*. It seems that the mandate for the *Independence Bank* is still in the process of drafting and specification, which suggests that it will have a broad scope. Experience indicates that this is inappropriate for the establishment of governmental development banks. It is better for the mandate to be restricted at start-up, to enhance the possibility of accountability, while making it obligatory to review the mandate after the completion of start-up. This should occur after appropriate time has elapsed, in order to consider amending the mandate (expanding it, narrowing it, or reformulating it). Article 3 of the Law lists goals of a general nature, such as “driving the investment and development process towards economic and social progress”, and “expanding the productive base of the national economy”. However, these goals do not clearly define priority economic sectors, social groups, or the development needs of specific target groups.
3. *Regulation, control and supervision*. Global studies highlight the incidence of failed experiments, in which the process of regulation and oversight was in the hands of the government exclusively, leading to conflicts of interest. Therefore, experts advise that the task of regulating governmental development banks should be entrusted to the Central Bank, and that it be subject, in general, to the procedures and laws governing traditional financial institutions. Laws may be amended in ways that facilitate, and are commensurate with, the mandate assigned to these banks. These can be designed to

maintain fair competition between institutions, with exceptions concerning certain sectors that do not qualify for conventional financing. Regulation and supervision systems must be strengthened with performance measurement and market control systems, to prevent the exploitation of special privileges, noting that the Bank is state-owned.

Regulating the relationship between the *Independence Bank,* the public sector and MFIs

International experience further indicates that there is a difference (in terms of both theory and practice) in the objectives of MFIs and development banks. MFIs seek to reduce poverty rates and empower poor/marginalized groups, while development banks aim to promote investment in large-scale development projects, consistent with governmental development plans, and in which the public sector usually plays a leading policy-making and investment role.

In Article 3 of Decree Law No.5 of 2021, one of the main objectives of the *Independence Bank for Investment and Development* is "stimulating investment in the financing of projects for start-ups and small- and medium-sized enterprises".[1] This intersects with the primary goal of most MFIs in Palestine, which is to target marginalized groups and those that do not qualify for the financial services of commercial banks. Therefore, there is concern about the nature of projects and social segments that the *Independence Bank* will target, and whether its role is to compete with existing institutions. These fears mainly stem from the large financial capabilities and portfolio that the Bank is expected to own, if it is indeed to serve as one of the main financial arms of the government. This would constitute a significant competitive advantage for the Bank, if it chooses to target micro-, small- and medium-sized enterprises. The competitive advantages enjoyed by the *Independence Bank* upon its entry to the market (if its mandate allows it) may restrict the entry of new MFIs, undermine the ability of existing MFIs institutions (especially smaller ones) to cover their costs, and threaten their financial sustainability.

1 https://maqam.najah.edu/ media/uploads/2021/02/legislations/بنك_الاستقلال.pdf

Based on many local and global indicators, government should not directly involve itself in providing credit or managing microfinance initiatives. Government institutions lack the technical skills, political independence and expertise to run these types of programs. In numerous, similar international experiences, the direct entry of government into the microfinance sector has led to high levels of default, or low rates of loan recovery, due to widespread rent-seeking behavior by borrowers offering loans at low interest rates to non-target groups or for non-priority financing. This drained public resources, distorted the microfinance market, and had a significant negative impact on the sustainability of MFIs.

Recommendations

There are great opportunities for the further growth of the microfinance sector and for overcoming the challenges that it faces, enabling it to play a greater role in promoting comprehensive and sustainable development in Palestine. This requires various relevant authorities to adopt appropriate measures and policies, including with regard to the proposed *Independence Bank*.

Palestine Monetary Authority (PMA)

- Examine the possibility of allowing MFIs to accept deposits, especially the deposits of the segments that they serve in their programs. The further study of global experience is valuable in this regard.
- Adopt subsidiarity and financial inclusion - as part of evaluation and control indicators - within the framework of microfinance policies.
- Secure temporary financing lines for MFIs, helping them to face emergencies resulting from Israeli policies that are hostile to the Palestinian economy. This will fortify MFIs, enabling them to access financial support at a time when they need to reschedule the debts owed by small-size projects affected by such policies.
- Establish a mechanism (under PMA supervision) to coordinate the strategic plans of MFIs (3-year plans). This mechanism leads to the setting of binding priorities and general directions for MFIs and related development finance institutions.

Microfinance Institutions (MFIs)

- Adopt a comprehensive concept of development that suits the Palestinian context, especially aspects related to fighting poverty and addressing occupation measures. This should include a general framework and a unified strategy for development and poverty alleviation, led by competent government institutions, in coordination with various actors in this field: the private sector, the civil-society sector and international organizations.
- Encourage or obligate clients to receive training (financial, technical and marketing) before offering loans to any category of small-size projects.
- Conduct an evaluation of development finance institutions (medium and large, local and international) operating in the Palestinian economy (emphasis on institutions that finance their projects based on their priorities and do not practice lending). The goal here is to benefit from successful experiences, helping to develop this sector for the service of overall development goals, through the sharing of various financing roles by banking and non-banking institutions.
- Avoid making consumer loans (or loans for consumption and not production), by tightening loan conditions. Consumer loans have low developmental impact and high risk of default.

Government

- Unify Palestinian laws across the West Bank and Gaza Strip concerning the development finance sector. This requires, at first, reviving the Legislative Council, and then reforming the Palestinian judiciary in a manner that preserves its independence. Unifying financial laws (and those related to MFIs) is part of this national duty.
- Establish funds or guarantee programs for financing provided by MFIs. This could be organized through PMA, or government, or both. This also requires the cooperation of the private sector (as part of their social responsibility initiatives) to achieve comprehensive, national development goals.
- Develop the banking law so that it takes into consideration the specificities of MFIs, and the future role of mainstream banks.
- Develop and activate complementarity in a microfinance system that includes MFIs, PMA, the judiciary, implementation agencies,

awareness/education institutions, guarantee funds and insurance companies.

Independence Bank for Investment and Development

- Create the enabling conditions for adopting successful models based on the experiences of other countries. Formulate the Bank's legal environment such that the Bank is immunized – to every extent possible - from the unstable economic/political reality of the Palestinian territories.
- Define (clearly) economic, societal and sectoral mandates (tasks), by answering various questions related to the Bank’s role and the nature of its work.
- A plausible option for the Bank’s role is not to enter the field of providing financial services, and to be satisfied with supervision and control, and perhaps providing loan guarantees and development policy guidelines.
- Alternatively, the Bank's priorities may target large development projects that the private sector is reluctant to implement, or is not able to perform alone. Here, it is advisable to focus on building partnerships between the Bank, the private sector and the civil-society sector across some areas.
- The Bank should serve as a guarantor of various development institutions, including MFIs.
- Study the possibility of integrating other government development finance institutions within the Bank (as a strategic objective), in order to benefit from economies of scale, as well as unified expertise enjoyed by all development financial institutions. This can allow for sectoral lending specialization, instead of competition and conflict.
- Emphasize – as part of the Bank's founding articles - the importance of the independence of the Board of Directors. Government should not have an overriding majority, in order to avoid both political interference and administrative/financial ineptitude that are both characteristic of the government sector.
- In all cases, in terms of supervision, control and regulation, the Bank must follow PMA systems, including requirements for privacy in accounts’ disclosure.