



Palestine Economic Policy Research Institute

# **A Critical Review of the Proposed Palestinian Banking Law**

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2. The terms of reference of the study are approved by an internal MAS scientific committee (consisting of senior researchers) to ensure accurate goals, appropriate use of scientific methodology and procedures and the timetable for completion.
3. The internal scientific committee supervises the work of the researcher or team of researchers through periodic progress reports.
4. The initial draft of the study is reviewed by the scientific committee for objective content-related amendments to be added to the second draft.
5. The second draft is then submitted for evaluation in accordance with the terms of reference to two or three external academic experts specializing in the subject. Provided that there is a positive evaluation by at least two experts, the researcher is asked to review the study taking into consideration the objective recommendations of these experts.
6. The study is presented for discussion at a public workshop attended by academics, researchers, and representatives from public and private sector institutions related to the subject of the research.
7. Comments and feedback from the workshop are incorporated into the study and the final draft is reviewed by the scientific committee to ensure that the necessary amendments have been made. The study is then edited.
8. Research papers written in English are translated into Arabic and published in both languages. An executive summary in English is attached to research papers written in Arabic.
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## Abstract

In its efforts to provide technical assistance to Palestinian policy makers to evaluate alternative policies and options needed to pursue sustainable development, Palestine Economic Policy Research Institute-MAS conducted a critical review of the proposed banking law. The study aimed at evaluating the proposed law, pointing out its weaknesses and required modifications that might improve its ability to enhance the competitiveness of the Palestinian banking sector and improve its role in financing development.

The main characteristics of the Palestinian banking sector were discussed and summarized as follows:

1. The banking sector is relatively new in Palestine. Thus, comparing it with banking sectors in other countries might be inappropriate and unfair. However, looking at the development of the sector over time is more appropriate. In this regard, a low share of direct credit facilities out of deposits is a clear issue. This share has increased steadily since 1994, from 27.6% and reached 35% in 1999. When indirect credit facilities were added, the share increased to 51.6% in 1999.
2. A relatively large role is played by Jordanian banks operating in the West Bank and Gaza. Their assets formed 76% of total banks' assets.
3. A high share of banks' deposits is invested abroad. The share was 72.7% out of deposits in 1998. This phenomenon is a result of several factors among which: absence of a Palestinian currency, which forces banks to transfer their excess reserves to central banks in related countries. Jordanian dinars are invested in Jordan, Israeli shekels are invested in Israel and US dollars are invested in international markets. Also, the volume of deposits exceeds investment opportunities that banks can or are willing to finance.
4. There is a high concentration of credit facilities in short and medium terms loans and facilities; most of them are given to commercial activities while production sectors are largely ignored.
5. The growth of the banking sector, both in volume and activities, was greater than the growth of regulatory capabilities of the Palestinian Monetary Authority and the judicial system needed to monitor the banking sector.
6. There is an overall weakness in the accounting and external auditing.

skills and practices.

The experience of other countries revealed that banking laws have changed along with the development of banking services, activities and competition in the banking sector. The economic development changes and developments have forced policy makers to consider alternative policies that can be pursued to enhance the role of banks as financial mediators and a source of financing economic activities. The main lessons that can be drawn out of the experience of other countries in the area of banking laws are:

1. Domestic economic conditions should be taken into consideration when formulating banking laws, especially the macroeconomic elements and the level of institutional and judicial structures.
2. It is emphasized that the revolutionary approach in reforming policies leads to complications, and the gradual relaxation approach of restrictions imposed on the banking sector is preferred. The gradual relaxation of restrictions should be linked with the level and development of regulatory and judicial capabilities.
3. Goals and activities should be designed to move from a relatively conservative banking law, in the first stage, to a more liberal and competitive laws in the second and third stages.

The first stage focuses on developing the laws and judicial structures mainly regulatory laws and developing the capacity of the court system to enforce business contracts, and streamline the banking institutions facing problems or expected to face problems. Also in this stage, interventions in directing credit facilities should be relaxed.

The second stage focuses on developing competition, and gradual opening of the market to new domestic banks, expanding the activities of existing banks, and encouraging competition among domestic banks.

A gradual introduction of international banks, to the domestic market should be allowed in the third stage given that domestic banks have developed their competitive capabilities to compete with international banks in the domestic market. Also, restrictions on capital movement, and credit facilities, and interest rate ceilings should be relaxed in the third stage. Also, complete relaxation of restrictions (liberal system) is introduced. In this stage domestic and international banks compete, with free capital movement intervention in interest rate setting.

Currently banks in the West Bank and Gaza Strip are in operating in the first and the second stage. These stages require a relatively conservative

banking law and strict monitoring of banks activities. However, the Palestinian banking sector cannot be totally isolated from regional and international developments and trends in the banking industry.

The proposed banking law considered some of these developments and ignored others. The following is a list of the major weaknesses and shortcomings of the proposed law:

1. It did not take into consideration the new trends in international financial systems such as increased competition between domestic and international banks in offering financial services, increased merger cases between banks to reduce risk, cost, and to improve their competitiveness and develop new services.
2. The proposed law ignored to a large extent new trends in financial services. It listed exclusively the services that banks can offer thus preventing them from delivering newly introduced financial services in international markets.
3. The proposed law did not deal with electronic systems that many banks have started to use to transfer money such as the SWIFT system and whether electronic data can be used in financial cases dealt with by courts.
4. The proposed law did not take into consideration whether banks can keep their records electronically or use new technologies like microfilms.
5. The proposed law did not deal with the new methods of payment – receipt that are widely spreading such as payments-receipt by the internet, and email. The world is moving toward the so called “electronic cash: e-cash” Also, it ignored how these payment –receipt methods can be dealt with in court cases.
6. The proposed law did not give enough attention to banking secrecy.
7. The proposed law did not show how to combat money laundry or money wash.
8. The proposed law did not show how to deal with those who write checks without sufficient funds.
9. Documents and requirements needed to be submitted to license a new bank are insufficient.
10. The proposed law did not give enough attention to merger and acquisition cases of banks.
11. The proposed law did not give attention to specialized banks and Islamic banks: how to deal with these banks, their activities, financing sources and uses of sources of these banks.

12. The proposed law did not consider the possibility of establishing a deposit insurance fund or institute, its role activities and its structure.
13. The proposed law did not show how to deal with the association of banks, how to develop the association's capabilities and its relationship with the Palestinian Monetary Authority.
14. The proposed law did not give enough details of the relationship and role of the Palestinian Monetary Authority with the cases of banks liquidation in a clear manner and how and when a bank license can be cancelled.

The study includes many other comments on the proposed banking law and gave several suggestions for completion and improvement.