سلطة النقد الفلسطينية
PALESTINE MONETARY AUTHORITY

The Microfinance Strategy

Microfinance Strategic Framework (2019–2023)

(2019-2023)

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Contents

Charts & Tabels

Acronyms and Abbreviations

AML/CFT	Anti-money laundering/countering financing of terrorism
GDP	Gross domestic product
GCC	Gulf Cooperation Council
FI	Financial inclusion
FSP	Financial services providers
HR	Human resources
IFC	International Finance Corporation
MENA	Middle East and North Africa
MF	Microfinance
MFB	Microfinance bank
MFI	Microfinance institution
MIX	Microfinance Information Exchange
MOFP	Ministry of Finance and Planning
NFIS	National Financial Inclusion Strategy
NBFI	Non-bank financial institution
NGO	Nongovernmental organization
PA	Palestinian Authority
PMA	Palestine Monetary Authority
SME	Small and medium-sized enterprise
SWOT	Strengths, Weaknesses, Opportunities, and Threats
VAT	Value-added tax

Forward

The microfinance sector is considered one of the main pillars of financial and social stability. It forms an important building block in the Palestinian national economy due to its social and developmental role in reaching marginalized groups, providing them with the opportunity to integrate into the formal financial sector and access basic financial products and services necessary for their active participation in the economy. This sector has also succeeded in enhancing the economic status of Palestinian women and young entrepreneurs. We are proud of the achievements within this sector and of the status that it holds. As decision-makers in economic policy, we must continue to provide all the support needed to maintain sector stability and sustainability. We aim to do this by developing a new strategic plan, as well as a legal and regulatory framework to encourage the sector's growth and the diversification of the products and services it provides. To that end, we are delighted to introduce the microfinance sector strategic framework for the next five years, coming on the back of a long process of strategic thinking and planning. In launching this strategy, we hope to inaugurate a new phase of growth and prosperity in this sector, one which is consistent with national efforts to promote the Palestinian economy within the framework of achieving sustainable economic development—contributing to shaping the economic future and social welfare of the Palestinian people. It is our pleasure to express our gratitude to the World Bank Group for their support during the preparation of this strategic framework. We also highly appreciate the contributions of our partners, namely the Palestinian Network for small and micro finance (SHARAKA), and the German Agency for International Cooperation (GIZ). A would also like to give special thanks to the Financial Sector Reform and Strengthening Initiative (FIRST), local partners, members of the National Strategy Committee, the Ministry of Finance and Planning, and the Ministry of National Economy, for their eager cooperation and extensive dialogue.

Governor

Azzam Shawwa

Azzam A Shawwa

Executive Summary

Building on the **Microfinance Policy Framework for Palestine** adopted in 2010, the Palestine Monetary Authority (PMA), with strategic support from the World Bank Group, launched a process to develop a strategy to strengthen the Palestinian microfinance industry. The new strategy is based on the **2010 Microfinance Policy Framework's** strategic objectives and actions for the next five years (2019–2023) to make sure that the accomplishments to date continue to improve access to finance for all Palestinians. The PMA's focus on microfinance reflects its evidence-based belief that a stronger microfinance sector helps low-income clients lift themselves out of poverty by extending financial services at appropriate terms; in turn those clients can grow their businesses, ensure their family's stability, and strengthen their communities. The Microfinance tools are now flexible and robust enough to penetrate underserved markets and can lead the way to increasing Palestinians' financial inclusion and sustainable economic development.

Although the Palestinian economy faces a number of challenges, the microfinance sector has grown beyond its nascent stage. Since 2010, the sector has more than doubled its number of active clients and experienced an average annual growth rate of about 14 percent. Nine microfinance providers currently provides microfinance products and services in the market, serving about 83,000 active borrowers, with an outstanding portfolio worth almost US$270 million. In order to build on this robust growth, the PMA is revisiting its current strategy in order to outline a new path forward for developing the sector. Such revision is aligned with the PMA's stated mission of building a truly inclusive financial system for all Palestinians while ensuring medium- to long-term stability for the financial sector.

To this end, the PMA assessed the microfinance sector's key strengths, weaknesses, opportunities, and threats (SWOT) as an input to the strategy.

Key strengths include strong regulation, few clients with multiple loans, links to the formal banking sector, and intersection with the new National Financial Inclusion Strategy (NFIS)[1]. Weaknesses include limited product diversification, weak transparency, limited competition, and the absence of smaller loans catering to unserved bottom-of-the-pyramid clients. Opportunities include advances in digital technology, increased banks' participation, extended outreach, and improved consumer protection. Identified threats include political instability resulting from the Israeli occupation and potential reputational risk that might result, for example, in external intervention in interest rates. All of these developments provide opportunities for the PMA to seize and leverage appropriate policy to strengthen microfinance institutions (MFIs) individually and the sector as a whole.

Given the PMA's commitment to improving access to finance and based on the above-mentioned SWOT analysis, the PMA's new strategy focuses on:

Emphasizing the sector's social mission: The PMA will strengthen its sector-wide approach towards inclusivity of bottom-of-the-pyramid clients, including women and those in rural communities and camps. The PMA will do that by encouraging MFIs to be less dependent on guarantees (especially salary guarantees), which exclude many low-income and very poor people, and favor cash flow-based lending methodologies that have proved their success globally. In addition, the PMA will encourage MFIs to adhere to the SMART Campaign consumer protection principles with emphasis on transparency and fair pricing.

Promoting product diversification: The PMA will address the lack of product diversity in the microfinance sector through encouraging MFIs to expand their product line to serve more segments which are not being catered to by the current product offerings. This can include more Islamic products, agricultural lending, and home improvement loans. The PMA

1 The PMA has approved a National Financial Inclusion Strategy in (2018) focusing on consumer protection and digital solutions.

will also address this by allowing different categories of MFIs to provide additional non-lending financial services either directly or in partnership with other financial services providers (FSPs). These services would include microinsurance, payments, money transfer, and other microbanking services, eventually including savings.

Improving the sector's efficiency: To improve efficiency, the PMA will take a two-pronged approach that addresses: (i) the digital opportunity: through promoting the use of digital technologies that address their application for both delivery channels and MFIs' back office efficiency, and (ii) increase competition: The PMA will ignite competition by introducing new institutional categories which will encourage new players to enter the market.

Furthermore, The PMA will join forces with other players in the sector to raise awareness of the importance of the sector and dispel erroneous conceptions with regards to interest rates as well as continue discussing with the Ministry of Finance and Planning (MOFP) and other PNA related parties improvements in current taxation/VAT on salaries, which disproportionately penalizes MFIs' operations.

Introducing tiered regulations: In order to build on the accomplishments achieved so far, maintain sector growth, and enable MFIs to provide new financial services, the PMA will introduce tiered regulations to allow for more types of organizations. This also includes encouraging banks into practicing microfinance through either: i) a "service company" model or ii) a "microcredit company" model.

Ensuring sector stability: The PMA will support these strategic goals without undermining sector-wide-stability. Thus, the PMA will continue its commitment to excellent oversight of the sector while focusing on an emerging issue: institutional governance. Additionally, the PMA will explore the potential benefits and opportunities in the formation of a credit guarantee facility which would help MFIs to absorb the impact of systemic risks (i.e.: occupation) and encourage them to serve new/riskier segments (i.e.: agriculture, solar, in addition to other sectors.).

The PMA will develop a package of incentives for the MFIs to encourage them to work toward accomplishing the targets and KPIs of the strategy. It will also look for ways to encourage small MFIs to merge together into one or more bigger player/s.

By implementing this new strategic framework, the PMA's expected outcomes for the microfinance sector by the end of 2023 are to: i) grow the number of borrowers to 150,000 and, the active portfolio to US$ 500 million, ii) the percentage of female borrowers to at least 50 percent, and iii) increase the share of small loans to at least 50 percent of total portfolio.

I Introduction

This Microfinance Strategic Framework (2019-2023) is the product of an iterative, strategic, and consultative process overseen by the PMA to create an enabling environment capable of absorbing the robust rate of growth of the Palestinian microfinance sector and addressing the challenges and opportunities that have emerged as a result.

The new framework builds on the **Microfinance Policy Framework for Palestine** adopted by the Palestine Monetary Authority (PMA) in 2010 to outline "strategic priorities for the microfinance sector needed to meet the continued national policy goals of economic independence and national prosperity through the adequate and appropriate channeling of resources." The 2010 framework supported the PMA's role as supervisor of the microfinance sector and prescribed a concrete strategy to develop a mature and integrated microfinance industry. It built on existing efforts to develop the first microfinance regulation for Palestine and to extend credit bureau services to microfinance institutions (MFIs).

The 2010 framework's vision[2] was:

"…to build a truly inclusive financial system allowing all Palestinians to have permanent access to a range of financial services and products that are provided in an efficient and cost-effective manner. The PMA is concerned with the overall stability of the financial system, the proper use of funds and the healthy growth of the financial sector and seeks to bring greater professionalization and rationalization to the microfinance sector by bringing these activities under its direct supervision".

Since the 2010 framework was adopted, the microfinance sector has grown more than doubling its number of active clients. Nine microfinance providers currently provides microfinance products and services in the market, serving about 83,000 active borrowers through a network of 107 branches, providing loans ranging from US$200–50,000, with an average outstanding loan balance of about US$3,225. The overall outstanding portfolio is about US$270 million. This growth was achieved despite a slowdown in 2014 and 2015 caused by the Gaza War.

In light of this expansion, the microfinance sector in Palestine now has an opportunity to outline a new path to maturity, one that moves it closer to relevant regional and international trends, ensures the sector grows sustainably, and addresses unmet demand. Given the critical juncture of the sector, the PMA recognizes the need for increased coordination and dialogue amongst stakeholders. To that end, this document is the work of an inclusive process involving input from the Microfinance Network (Sharakeh), donor partners (German Cooperation), key ministries on the Microfinance National Committee including the Ministry of Finance and Planning and the Ministry of National Economy. Moving forward, this 2019-2023 framework seeks to stimulate a higher level of private sector participation to further support the PMA in meeting its objectives over the next five years.

The Microfinance Strategic Framework Document is structured in three sections. The first section provides an overview of the current situation in Palestine's microfinance industry. (Section II) It presents the findings of a SWOT analysis of the microfinance sector. (Section III) It then lays out the three pillars and two foundational components of the PMA's vision for the sector from 2019-2023.

2 This vision was to be achieved through ratification of the following principles: i) An enabling policy environment under which a supportive legal and regulatory framework exists for microfinance; ii) A competitive capital market in which a diversity of private debt and equity investment is encouraged and not required to compete with subsidized capitalization of loan portfolios; iii) A continuum of financial service providers (i.e., banks, non-deposit-taking MFIs, nongovernmental organizations (NGOs) that have the institutional setup and capacity skills to service the market in an efficient, market-oriented, and viable manner.

II Analysis of the Current Microfinance Situation in Palestine

II.Macroeconomic Situation

As of end 2017, Palestine's total population was 4.78 million, of which 2.88 million lived in the West Bank and 1.9 million in Gaza.[3] The majority (76.2 percent) of the population lived in urban areas.[4] Although gross domestic product (GDP) growth in 2016 reached 4.7 percent, this was largely due to reconstruction efforts after the 2014–2015 Gaza War, which cost the economy US$1.7 billion.

This translated to a GDP per capita that reached US$3,094 (current US dollars) in 2017, and unemployment remained high at 27.8 percent. [5] Unemployment in Gaza, at 41.1 percent, is more than twice as high as in the West Bank. Furthermore, youth unemployment (ages 15 to 24) reached 44.1 percent in 2017,[6] most heavily concentrated in Gaza, where over 60 percent of youth aged 15–29 are unemployed.[7]

The Palestinian economy currently faces a number of challenges, many stemming from Palestine's difficult political and security environment. Nonetheless, promising developments in its young population, high level of education, and self-employment rates indicate that an opportunity exists for both the microfinance sector and its clients to grow and contribute to the well-being of all Palestinians.

II.Palestine's Financial Sector and Access to Finance

From a macroeconomic perspective, financial inclusion[8] has been proven to be positively correlated to economic growth and a reduction in socioeconomic inequalities. As stated in the **2010 Microfinance Policy Framework for Palestine**, "access to finance leads to increases in household income and economic security, the accumulation of assets, and reductions in economic vulnerability." The creation of wealth in this way further supports the national economy by creating demand for other goods and services (especially nutrition, education, and health care), and by stimulating local economies through greater consumption. In addition, untapped savings from the informal sector represent a large portion of investment capital available for local investment needed to spur economic growth. On a micro level, for low-income individuals and households, financial inclusion is critical for improving household welfare, enhancing productive investment, and managing economic shocks.

Yet according to Findex 2017 data, only 25 percent of the adult population in Palestine (age 15+) hold accounts at a financial institution.[9] This figure, which is negatively correlated with gender (only 16 percent of women over 15 years of age hold accounts), persists despite the presence of banks, MFIs, insurance companies, and security, mortgage, and leasing companies. In addition, national savings rates are low: only 26.9 percent of the 15+ year old population saves in any form, compared to 33.4 percent for the Middle East and North Africa (MENA) region as a whole. However, this includes informal saving methods. The rate drops to 6.0 percent for those who have saved formally at a financial institution, well below the MENA region rate of 12.4 percent. Palestine has a higher rate of informal savings via savings clubs or other informal means, with 12.3 percent of the adult population (15+ years old) saving informally, as

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3 Palestinian Central Bureau of Statistics.

4 The United Nations Population Division's World Urbanization Prospects 2018. Retrieved from the World Development Indicators Database (including east Jerusalem).

5 World Bank national accounts data. Retrieved from the World Development Indicators Database.

6 International Labor Organization, ILOSTAT database.

7 World Bank. 2017. Palestine's Economic Outlook - October 2017. World Bank, Washington, DC.

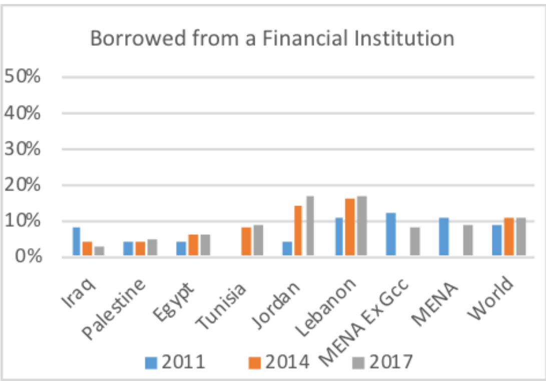
8 The State of Palestine's National Financial Inclusion Strategy (NFIS) 2018–2025 defines financial inclusion as "enhancing access to, and use of, financial products and services by all segments of the society via formal channels, while meeting their needs in a timely and affordable manner, protecting their rights and promoting their financial knowledge to enable them to make well-informed financial decisions."

9 World Bank, Global Findex Database (2017).

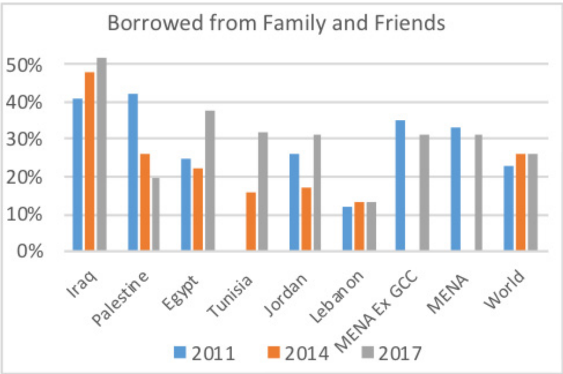
compared to the MENA regional average of informal saving of 8 percent for that same category.[10]

A similar analysis of lending by provider shows that Palestine lags behind the region in loans from a financial institution in the past year (3 percent). Palestine posts lower rates of informal lending from friends and family (20 percent) than the region (e.g., 30 percent for MENA counties, excluding high-income), but significantly higher rates of lending via store credit (34 percent) compared to 18 percent (2011) for the MENA region (Figure 1).

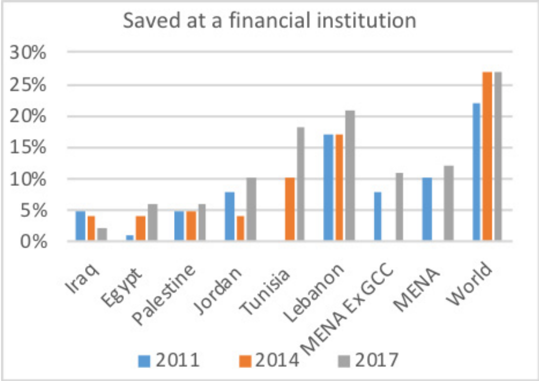
Figure 1: Palestine's savings and lending indicators compared to MENA region and world averages

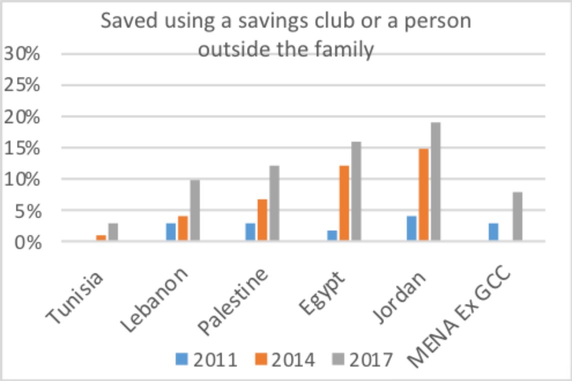


Source: Findex 2017 data.



Source: Findex 2017 data.





Source: Findex 2017 data. Source: Findex 2017 data.

Note 1: MENA Ex GCC refers to Middle East and North Africa excluding high-income countries.

Note 2: Annex I includes additional pertinent data on this topic.

II.3 Current State of the Microfinance Sector in Palestine

No official definition of microfinance exists in Palestine. Microenterprises are currently included in the broader PMA category of small and medium enterprises (SMEs)[11]. However, the term microfinance in this strategy document refers to the provision of loans, insurance, money transfers and eventually savings accounts and other banking services to customers with income that lack access to conventional financial services.

The microfinance sector in Palestine has undergone significant changes since the PMA took over its oversight in 2011. Many of these changes and developments have enabled the sector's robust growth, in particular the:

Consolidation of licensing and registration requirements under the PMA: Regulation No. (132) of 2011 for the Licensing and Monitoring of Specialized Lending Institutions gave the PMA the authority to license, regulate, and

10 MENA regional average excluding high-income countries.

11 PMA defines SME as any enterprise with less than US$7 million in annual gross sales and less than 25 employees.

supervise the sector. This streamlined MFI reporting requirements for many MFIs that were previously registered as NGOs and reported to the Ministry of Interior. The Regulation covered both for-profit and non-profit companies, providing strict guidance on the requirements to obtain a license, such as minimum capital and branching requirements. Many smaller operators initially exited the market, and those that remained benefited from better portfolio quality management, more robust institutional structures, growing portfolios, and improved transparency; this in turn led to an increase in funding for the sector.

Launch of a credit registry: In 2008, the PMA launched "Sijil-ly", the credit registry system into which the microfinance sector in Palestine is now fully integrated. The system provides an online, real-time service for accessing borrowers' credit histories, as well as a credit scoring system. MFIs can report their lending activity to the credit registry and inquire about borrowers before issuing a loan (required by regulation). This reduces the overlap among MFI borrowers, reducing the risk of over-indebtedness.

Establishment of banks as mediums: Some banks practice microfinance or provide direct funding to microfinance institutions (MFIs) and have facilitated MFIs by providing channels to communicate with clients to disburse loans or collect payments, or deduct repayments from the salaries of delinquent clients.

From 2011 to 2018, the microfinance sector has more than doubled its number of active clients, from 37,000 to 83,000; the number of branches grew from 60 to 107; and the outstanding sector portfolio grew from around US$60 million to about US$270 million.

Microfinance providers, most are under the supervision of the PMA. It is worth noting that: i) one MFI accounts for almost one-half of the market; and ii) the four largest MFIs account for more than 80 percent of borrowers and 75 percent of the sector portfolio. About 70 percent of borrowers and of the outstanding portfolio are concentrated in the West Bank.

There remains an untapped segment of the population yet to be served by the microfinance sector. An extensive study of the Palestinian microfinance sector conducted in 2017[12] estimated that the market has between 330,000 and 430,000 potential borrowers. Of those, the study estimated that between 245,000 and 345,000 are not being served. Using the average outstanding balance of Palestinian MFIs as of end 2016 (US$2,570), the potential market gap is between US$630–900 million. These numbers indicate that the microfinance sector is facing a critical opportunity to build on progress that has been made since the PMA assumed oversight of the sector. These opportunities, along with the strengths, weaknesses, and threats presented by the sector are outlined in greater detail in the below SWOT analysis.

12 IFC 2017. "Microfinance in Palestine: Developments, Challenges and Future Prospects." International Finance Corporation, Washington, DC.

III SWOT Analysis of the Microfinance Sector in Palestine

As a key input to the new Microfinance Strategic Framework (2019–2023), the PMA conducted a SWOT (strengths, weaknesses, opportunities, and threats) analysis of the microfinance sector. Table 1, Table 2, Table 3, and Table 4 summarize the key findings of the SWOT.

Table 1: The microfinance sector in Palestine: Strengths

Financial Inclusion Strategy	The PMA was one of the first countries in the region which has developed and approved a National Financial Inclusion Strategy.
Strong regulation and supervision	MFIs are more closely regulated than elsewhere in the MENA region, in terms of both the number of requirements and the intensity and frequency of inspections.[13] The absence of policies that could constrain or distort the market (e.g., interest rate ceilings, or subsidies) further improves the regulatory environment.
Few multiple loans	A strong credit registry allows for a good understanding of clients' level of indebtedness. Partially as a consequence, the percentage of clients who have loans with more than one financial institution is very low (5.6 percent[14]), a feature normally correlated with good portfolio quality.
Links to the formal banking sector	The percentage of banks' share out of total liabilities of the microfinance sector is on the increase.[15] MFIs rely on banks for borrowing and also use them for the bulk of their cash transactions (disbursements, collections, and so on).
Guarantee fund	Guarantee funds are present and operational in Palestine; however, they are in need of development and activation. Guarantees can assist the MFIs to mitigate the risk of going into segments they hesitate to serve such as agriculture and smaller loans segments.

While these important accomplishments give the PMA and the sector reason to celebrate, several areas for improvement (weaknesses) remain.

13 Annex IV describes the instructions and regulations relating the microfinance sector.

14 This rate is far higher (can reach 40 percent) in other Arab countries, which partially explains Palestine's higher average loan balance; in those other countries, almost one-half of borrowers borrow from at least two MFIs, significantly reducing the average loan balance.

15 As per the IFC report, the percentage of banks from MFIs' liabilities increased from 16 percent in 2012 to 34 percent in 2016. This is an increase of US$41 million, or 18 percent of the total portfolio of the sector.

Table 2: The microfinance sector in Palestine: Weaknesses

Limited product diversification	Beyond credit, MFIs offer few other products. Savings[16] are currently only available through banks, and options for insurance services, money transfers, or remittances are prohibited. Following the trend of many majority Muslim countries, where Islamic finance has already been mainstreamed within the formal financial system, a better understanding of this practice should be promoted within the microfinance sector.
Lack of smaller loans to unserved bottom-of-the pyramid potential clients.	Political pressure on MFIs to offer lower interest rates has resulted in an adverse cycle whereby MFIs offer larger loan sizes[17], increased loan terms, and require higher collateral requirements. As a result, MFIs are disincentivized to go deeper in the market and provide smaller loans that serve those who are at the bottom of the pyramid.
Guarantees	Given the unstable political situation, microloans in Palestine are quite heavily collateralized/guaranteed. Frequent practice at both banks and MFIs is for clients to secure a postdated check and/or a cosigner who agrees to an automatic deduction in case of arrears. Such practice detracts from the traditional methodology for credit assessment, which relies mostly on character and cash flow analysis, reinforced by personal guarantors.
Lack of competition	The sector could benefit from more competition. Current players include a handful of MFIs and a couple of banks. The market is very concentrated. Four largest MFIs account for more than 80 percent of borrowers and 75 percent of the sector portfolio. Several MFIs are still very small, have frail governance, and are still incurring losses though they have been in operations for a decade or two.
Transparency	Because of indiscriminate use of flat and declining balance rates, as well as additional fees, effective rates are not always clear or transparent. This makes rate comparison complicated and discourages competition.
Gender	An opportunity exists to reduce the gender gap and help bring women's account ownership more in line with men's through the introduction and implementation of appropriate policies.
Lack of consumer education and awareness	Lack of consumer education and awareness on how microfinance works.

Nevertheless, several global and domestic trends lend themselves to emerging opportunities for Palestine's microfinance sector to expand and mature.

16 Financial cooperatives provide a sort of savings scheme to their members as shares, but again, their outreach and amounts are very modest.

17 The average loan balance is very high (close to US$2,500 at end 2016 and jumping to US$3,225 at end 2018), which suggests two things: i) an average loan size at disbursement of approximately US$5,000–6,000; and ii) rising average loan sizes (Annex I shows the growth of the average loan balance between 20122018-). Even after factoring in Palestine's higher-than-average cost of living as well as its low rate of clients with multiple loans, average loan sizes are still quite high when compared to the average loan size for MENA (the regional average loan size for MENA is US$ 610 as per the MIX market). The push on financial intermediaries towards larger loan sizes has also resulted in longer loan terms when compared to other countries in order to keep monthly payments low while increasing total loan amounts. Elsewhere, typical microloans have a relatively short term, with norms of 6 to 18 months. Terms for Palestinian microloans tend to be 4 to 5 times longer. With few exceptions, maturities of 36 to 60 months are the norm in Palestine.

Table 3: The microfinance sector in Palestine: Opportunities

Advances in mobile technology and	The use of digital technologies as a tool to deepen financial inclusion can be accelerated and particularly aimed at: Distribution channels: The relatively high penetration of mobile phones technology and mobile banking. Back office: Increased utilization of technology at MFIs' back offices would help reduce operating expenses.
Worldwide standards and consensus on consumer protection in microfinance	Much can be gained by ensuring better compliance with recent norms covering MFIs' governance and consumer protection. This includes adoption of international guidelines for consumer protection, such as The SMART Campaign, particularly its guidelines for increased transparency around pricing.
Increased collaboration between microfinance and banks	In recent years the microfinance sector became more integrated in the banking sector, largely via funding. As a result, banks have learned more about microfinance, MFIs' operations, and the fact that microlending can be profitable. Thus, an opportunity exists to incentivize them to downscale to the microfinance market to increase competition and reach more clients.
Low market penetration, especially in rural areas	The market has room to grow given its low levels of market penetration, especially in rural areas. Because MFIs have not yet fully saturated the market, the PMA can support policies that promote outreach while ensuring that certain protections, transparency, and other criteria are met.
Tiered regulations and the allowance of additional institutional types	Regulatory progress to date has laid the groundwork for the potential entry of new institutional categories, such as the non-bank financial institution/ microfinance bank (NBFI/MFB) category, that can offer more products and services including transfers, insurance and eventually savings. The expansion of products and services brought about by new categories can increase outreach, particularly to youth and women, and lead to a higher number of serviced clients. The PMA can support new regulatory conditions and requirements needed to fully enable new institutional categories. The opportunity to access an untapped client base can prompt the entry of new players willing to start institutions that meet these requirements or to work through existing institutions to fulfill the requirements needed for them to operate under a new category. Such a process could also encourage an institutional evolution toward more professionally run companies that would benefit from economies of scale and operational efficiency. The tiered regulation also applies to existing institutions, enabling them to offer more services in compensation for their adhesion to the more stringent requirements. Thus, it provides an opportunity for MFIs to diversify their product offering and permitting maturing MFIs to evolve their legal structure in a financially prudent manner (e.g., from a nongovernmental organization (NGO) to a specialized microfinance vehicle and, eventually, to a microfinance bank).

Finally, the following threats to Palestine's microfinance sector must be recognized and addressed.

Table 4: The microfinance sector in Palestine: Threats

Enabling environment	Political instability and the frequent crises resulting from the Israeli occupation result in a difficult and unpredictable enabling environment, discouraging investment, innovation, and risk taking.
Interventionism	Distortionary interventions and/or imbalanced regulation have the potential to constrain or distort the market. Initiatives, such as interest rate caps and subsidized lending, could also lead to financial exclusion and other negative effects that include MFIs taking advantage of the availability of funding at the expense of borrowers and /or discouraging the entry of private capital.
External pressure to decrease interest rates	Effective rates in Palestine are quite low, among the lowest anywhere in the MENA region. Nevertheless, significant external pressure remains to reduce rates further. This pressure results, at least partially, from a poor understanding of the special nature of microfinance and inaccurate comparisons of microfinance rates to those of banks.[18]

IV New Strategic Framework for the Future of the Microfinance Sector in Palestine

Thus far the PMA's prudent regulation of the microfinance industry has provided stability to the sector, in spite of a challenging political and economic context. This stability provides the foundation for the new strategic vision and remains an important foundational principle in the Microfinance Strategic Framework (2019–2023). The goal of this new strategic framework is to continue building a truly stable, sustainable, and inclusive financial system that allows all Palestinians to have permanent access to a range of financial services and products provided in an efficient and cost-effective manner.

The PMA's main concerns are: the overall growth and maturity of the financial system; the institutions governance; and product diversification that brings vital financial services to all Palestinians through a transparent and efficient financial methodology and culture. These three strategic pillars, supported by regulatory stability and tiered regulation, will ensure Palestinians' improved access to finance and improved the sustainable economic development.

This strategy is guided by a vision of:

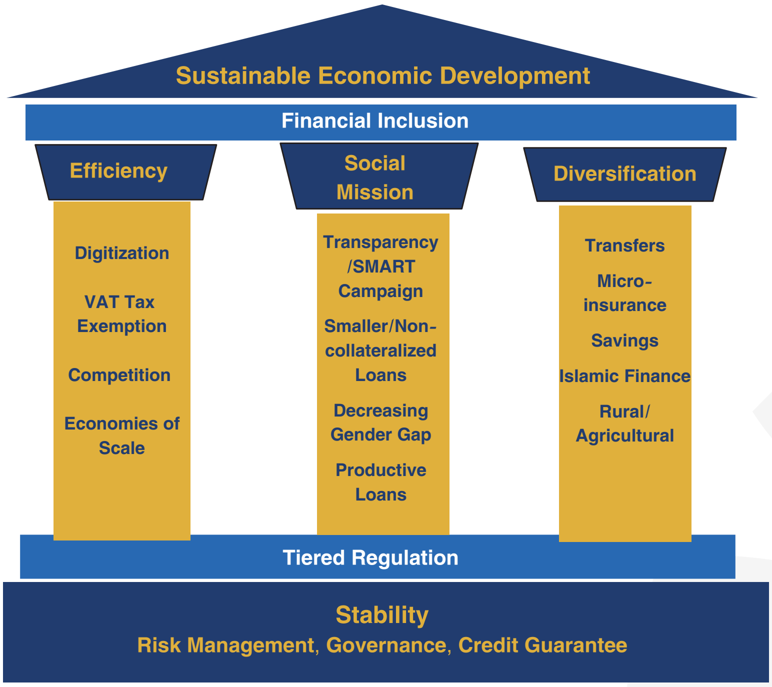
An efficient and sustainable sector that will be an economic and developmental lever that will expand the productive base and contribute to alleviation poverty and unemployment and it will be an incubator for micro and small entrepreneurs and innovators.

Mission

Encourage the institutions to provide diversified financial services efficiently and effectively in accordance with the best standards and practices to protect the rights of customers, including all categories and sectors to contribute to economic development and enhance employment opportunities, increase production, and fight poverty and unemployment reaching sustainable institutions and enhance financial stability.

18 MFIs borrow a good portion of their money from these banks, pay the banks' interest rate on that, and relend that money to their borrowers. Additionally, the very structure of MFIs, requiring them to hire a large number of loan officers, lends itself to high operational costs, which in turn drive up interest rates. In order to allow a margin for profit, MFIs must charge a high enough interest rate that will cover not only the cost of funds but also their operational and risk costs.

Figure 2: The microfinance sector in Palestine: Pillars of the Strategic Framework (2019–2023)



Based on the SWOT analysis and multiple interviews conducted with microfinance sector stakeholders, the PMA believes this new strategic vision will be best achieved through:

Emphasizing the sector's social mission: The PMA will continue to focus its sector-wide approach towards inclusivity of bottom-of-the-pyramid clients, including women and those in rural communities and camps. through encouraging MFIs to be less dependent on guarantees (especially salary guarantees), which exclude many low-income and very poor people, and adopt cash flow-based lending methodologies that have proved their success globally, including the use of credit scoring backed by better data. In addition, the PMA will encourage MFIs to adopt and adhere to the SMART Campaign consumer protection principles, with emphasis on transparency and fair pricing. Furthermore, to help raise public awareness on the sector, the PMA with other players- in the sector to foster awareness on the importance of the sector

Thru making the data available, the PMA will also encourage Research Institutes and Universities to conduct studies on measure the impact of the microfinance sector in Palestine on job creation and alleviating poverty.

Promoting product diversification: The PMA will address the lack of product diversity in the microfinance sector through encouraging MFIs to expand their product line to serve more segments which are not being catered to by the current product offerings. This can include more Islamic products, agricultural lending, home improvement loans, green lending and entrepreneurs. The PMA will also address this by allowing different categories of MFIs to provide other non-lending financial services either directly or in partnership with other financial services providers (FSPs). These services would include microinsurance, payments, money transfer, and other microbanking services, eventually including savings.

Improving the sector's efficiency: To improve efficiency, the PMA will take a two-pronged approach that addresses i) the digital opportunity[19]: through promoting the use of digital technologies that address their application for both delivery channels (i.e. mobile and online banking) and MFIs' back office efficiency (e.g., streamlined digital processes and automatic credit scoring and risk alerts.) ii) low competition: The PMA will ignite competition by introducing new institutional categories which will encourage new players to enter the market. This includes encouraging banks to downscale into the microfinance sector through either: i) a "service company"[20] model, by allowing banks to outsource a main banking activity – microlending, in this case to a service company which is fully or partially owned by the bank; or ii) a "microcredit company" model, by waving the "lending to related parties" control to encourage banks to spin off their microlending activities into independent microcredit companies. This will include different categories of for-profit companies where the level of financial leverage and types of other financial services a company can provide is linked to the capital of the company and the level of supervision/regulation it is subjected for. It will also include allowing banks to establish microcredit companies without being subjected to the lending to related parties ceiling or service companies which can book the loans on the bank's balance sheet. Furthermore and over time, this could include opening the door for microfinance banks that can mobilize savings from the public.

Furthermore, The PMA will continue discussing with the Ministry of Finance and Planning and other PA related parties' improvements in current taxation/VAT on salaries[21], which disproportionately penalizes MFIs' operations; and ii) further protect interest rates from populist initiatives to impose interest rate caps.

Introducing tiered regulations: In order to build on the accomplishments achieved so far, maintain sector growth, and enable MFIs to provide new financial services, the PMA will introduce tiered regulations to allow for more types of organizations.[22] In addition, the PMA will continue its practice of tightening conditions and requirements in exchange for organizations being allowed to offer more services and have more leverage[23].

Ensuring sector stability: The PMA will support these strategic goals without undermining the sector-wide-stability identified as a strength in the microfinance sector. Thus, the PMA will continue its commitment to excellent oversight of the sector while focusing on an emerging issue. As the PMA expands the regulatory framework for microfinance, governance of MFIs will require special attention. Ensuring implementation of the recently enacted PMA regulation concerning governance will be a priority. Additionally, the PMA will explore the potential benefits and opportunities in the formation of a credit guarantee facility which could help MFIs to absorb the impact of systemic risks (i.e.: occupation) and encourage them to serve new/riskier segments (i.e.: agriculture, solar, etc..).

The PMA will develop a package of incentives (such as higher leverage ratio and allowing more services than just lending, etc.) for the MFIs to encourage them to work toward accomplishing the targets and KPIs of the strategy specially those related to enhancing the social mission by reaching more poor people and women and focusing more on lending to productive activities. It will also look for ways to encourage small MFIs to merge together into one or more bigger player/s.

By implementing this new strategic framework, the PMA's expected outcomes for the microfinance sector by the end of 2023 are to: i) grow the number of borrowers to 150,000 and the active portfolio to US$ 500 million, ii) the percentage of female borrowers to at least 50 percent, and ii) increase the share of small loans to at least 50 percent of total portfolio.

19 The opportunity associated with Palestine's new 3G mobile technology.

20 More details in annex II.

21 Salaries in MFIs are usually 65-70% of total operation cost.

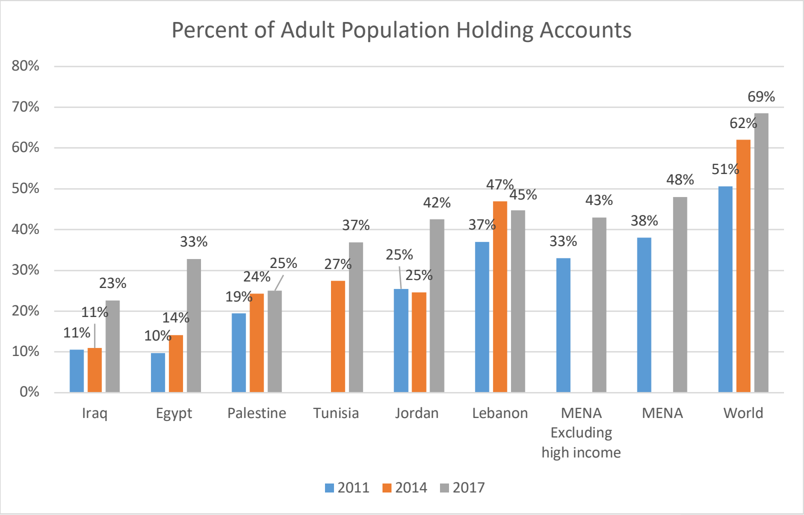
22 Annex V shows an example of an indicative tiered regulation structure.

23 For example, a microfinance bank taking deposits would need higher minimum capital and more supervision than an MFI only offering loans. The tiered regulation also covers institutions that are in between, enabling them to offer more services while adhering to more stringent requirements. Thus providing the opportunity for MFIs to diversify their product offering, and permitting maturing MFIs to evolve their legal structure in a financially prudent manner (e.g., from a nongovernmental organization (NGO) to a specialized microfinance vehicle to a microfinance bank).

Annex I – Access to Finance in Palestine and State of the Microfinance Sector

In Palestine, 24.2 percent of the population above the age of 15 held an account at a financial institution in 2017. This compares to an average of 48 percent across the MENA region, though an examination of this statistic by country reveals that this average is skewed by a handful of countries with very low rates. Comparing Palestine to its peer group, the gap is even larger.

Figure AI.1: Percent of population in MENA countries holding accounts at a formal institution



Source: Global FINDEX 2017 data.

Table AI.1 provides a snapshot of Palestinians' access to finance based on eight financial inclusion indicators.

Table AI.1: Palestinians' access to finance

Financial inclusion Indicators	2011	2014	2017
Account (% of those aged 15+)	19	24	25
Account, female (% aged 15+)	10	21	16
Account, poorest 40% (% aged 15+)	8	16	12
Account, young adults (% aged 15-24)	9	11	12
Borrowed from a financial institution in the past year (% aged 15+)	4	4	5
Borrowed from a financial institution in the past year, female (% aged 15+)	2	3	3
Borrowed from a financial institution in the past year, poorest 40% (% aged 15+)	4	2	3
Borrowed from a financial institution in the past year, young adults (% aged 15-24)	2	1	1

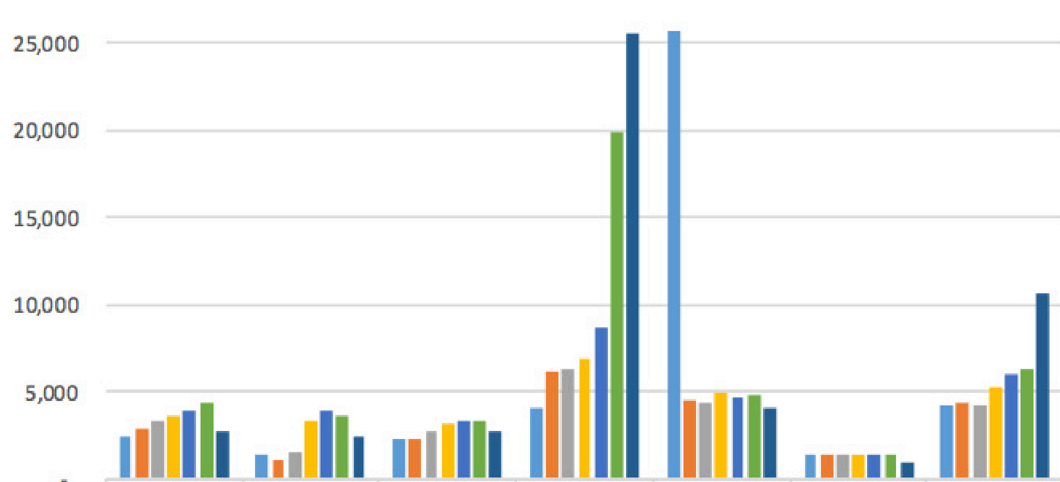
Source: Global FINDEX 2017 data.

Women accountholders (16 percent of the 15+ age population) lag behind the national percent of accountholders (25 percent). This gap persists across all financial products except outstanding loans from MFIs, where the gender gap is minimal (0.2 percent) and favors women. This is due to the credit policy of MFIs that emphasizes targeting women.

The low levels of access to finance are due in large part to the low number of points of service. The 2017 Global FINDEX survey found that in 2015 the number of banking branches reached 11 per 100,000 adults, 4.5 branches for every 100 km2, and 22.2 ATMs for every 100,000 adults. Additionally, no mobile financial services were offered by any mobile provider at the time of the survey.

Palestinians' average outstanding loan balance, US$3,225 is high for the MENA region (Figure AI.2), though the average loan size drops to US$2,701 if the MFIs PDF and PBC are removed. Even so, the average loan size is high. Among the reasons cited are Palestine's higher cost of living and its unique economic situation, such as links to the Israeli economy. Nonetheless, the rising trend in average loan balances has been ongoing for several years.

Figure AI.2: Average loan sizes by MFI, 2012–2018



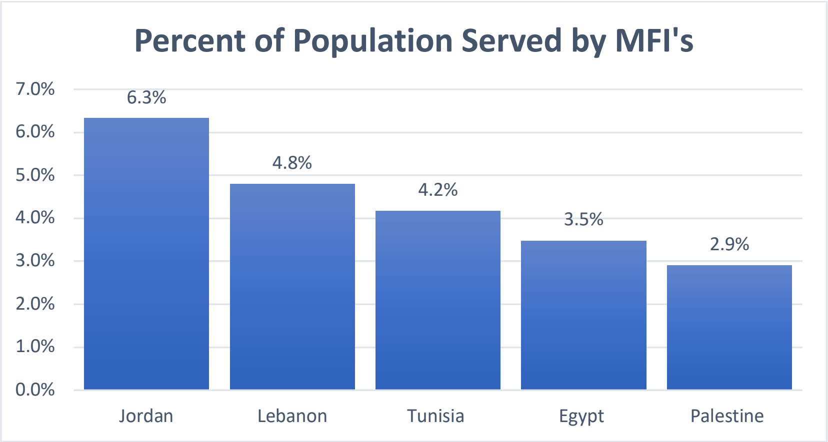
	ACAD	ASALA	FATEN	PDF	REEF	UNRWA	VITAS
2012	2,520	1,356	2,280	4,072	25,718	1,449	4,228
2013	2,846	1,190	2,317	6,134	4,521	1,412	4,408
2014	3,359	1,543	2,690	6,352	4,351	1,399	4,197
2015	3,681	3,285	3,260	6,943	4,956	1,353	5,236
2016	3,923	4,016	3,348	8,782	4,686	1,406	6,017
2017	4,370	3,642	3,383	19,884	4,832	1,437	6,285
2018	2,796	2,533	2,814	25,548	4,034	935	10,715

Source: Sharakeh Microfinance Network.

On the other hand, Palestine's interest rates are the lowest in the world. Notably, average interest rates dropped 4 percent from 2010 to 2016. However, it is important to note that these low rates might be coming at the cost of MFIs being pushed to provide relatively large loans and long terms. Indeed, low rates are typically associated with lower operating expense ratios, which usually require a higher loan balance. As a consequence, financial intermediaries feel compelled to require strong collateral (for example, garnished wages); in doing so, they exclude the very poor and those who do not have access to that type of collateral.

Figure A1.2 shows the percent of the Palestinian population served by MFIs compared to other MENA region countries.

Figure AI.2: Percent of MENA countries' populations served by MFIs, 2017



Source: Tanmeya, Sanad, FRA Egypt, PCBS, and World Bank population data.

Annex II – Making the Case for Service Companies

While banks are already participants in the microfinance sector, much could be accomplished by encouraging and incentivizing them to significantly increase their presence. Established banks can offer the field of microfinance several advantages not generally available to NGOs or transformed MFIs. These advantages make them potentially strong competitors and thus can be a major factor in facilitating financial inclusion.

As discussed in "The Service Company Model: A New Strategy for Banks in Microfinance" published by ACCION International, key advantages of banks include:

Physical and Human Infrastructure. Large banks often have an extensive network of branches and access to an advanced technology infrastructure that can substantially cut operating costs. Banks are also well staffed with skilled individuals in key areas such as human resources, customer service, information technology, marketing, and legal and financial management.

Market Presence and Brand Recognition. Banks that have been in the market for a long time are well known to the public and have a recognized brand. Most banks already have connections in middle- and low-income populations through other services such as savings accounts or payment services.

Access to Plentiful and Low-Cost Funds. Banks normally raise funds quickly and at a relatively low cost.

Low Cost Structure. Banks generally have a much lower operating cost structure than traditional MFIs.

On the other hand, several factors tend to keep banks from significant entry into microenterprise lending:

Market Knowledge. Banks lack an understanding of the microfinance market and its clientele and often dismiss this segment as both too risky and too expensive. Even if a bank recognizes that microfinance can be profitable, the resulting portfolio size may be viewed as too small relative to the level of effort required to manage a microfinance operation.

Credit Methodology. Banks often attempt to serve the market with inappropriate credit methodologies, for example by using adaptations of traditional commercial or consumer lending approaches. When these methodologies fail, they reinforce the idea that microfinance is not promising.

Conservative Corporate Culture. The long tradition of banking is closely tied to specific ways of doing business, and it is difficult for banking professionals to change. With a conservative outlook, banks may tend to burden microfinance with policies and procedures that prevent its success, or they may be very slow to recognize and make needed changes. This is especially true for large, bureaucratic banks.

Human Resources. Microenterprise credit requires staff who are comfortable working in the neighborhoods where clients live and work and who must be highly productive to succeed. These requirements of microfinance are often incompatible with the human resources profile and policies of the staff of banks.

Taking all these factors into account, when considering entering the microfinance space, banks typically use four models to structure their participation in microfinance:

Strategic Alliances. A simple, low-cost way for banks to enter microfinance is to form strategic alliances with nonbanking institutions already serving the microfinance market. The simplest form of alliance is a loan to an MFI, and banks around the world are already lending to MFIs. However, a simple lending relationship fails to take advantage of most of the special benefits banks can offer.

Internal Unit. Banks can create microfinance units or even introduce a microcredit product within an existing unit. While the creation of an internal unit can be successful, two major disadvantages must be overcome. First, the bank must somehow differentiate the staff of the microfinance unit from the staff of the mainstream bank to build a distinct corporate culture within the former. Probably more difficult to overcome is the lack of independent governance for the microfinance unit. Without separate governance of the microfinance unit, critical decisions concerning the microfinance operation are made by groups of bankers with limited exposure to or concern for microfinance. The result can be unworkable policy decisions, lack of sufficient internal resource allocation, and even about-faces regarding commitment to the sector.

Financial Subsidiary. Banks can establish a separate financial subsidiary to serve the microfinance sector. These subsidiaries can be wholly owned joint ventures with other investors. The financial subsidiary option is attractive when banks and technical assistance providers and/or microfinance operators seek to work together in a transparent and commercial manner without disturbing the operations of the bank; it creates a separate staffing structure, management, and governance, giving the microfinance operation its independence. However, the financial subsidiary requires its own substantial equity capital base and thus is less conducive to taking advantage of some of the benefits of the internal unit: it is more likely to involve duplication of staff functions at the headquarters level, as the subsidiary usually has parallel accounting, human resources, and information technology departments.

The Service Company Model. A microfinance service company is a nonfinancial company that provides loan origination and credit administration services to a bank. The service company does all the work of promoting, evaluating, approving, tracking, and collecting loans; however, the loans themselves are on the books of the bank. In return for providing these services to the bank, the service company is paid a fee. The service company employs loan officers and other microfinance program staff, while the bank furnishes services to the service company (such as teller support, human resources, or information technology). The service company can be a wholly owned subsidiary of the bank or it can involve additional investors. The service company model seeks to draw on the best elements of each of the three models of bank involvement discussed above, while addressing their drawbacks. Legally, a service company is a variant of the subsidiary model with the crucial distinction that it is not a financial institution. This distinction gives it important advantages. A nonfinancial company does not require a separate banking license, is not separately supervised by the banking authorities, and does not require a large equity base. It is thus much easier and less costly to launch and operate than a financial subsidiary.

Experiences in other regions/countries suggest important advantages of utilizing the service company model, as illustrated by two examples of its successful implementation:

Case Study from Haiti

Some 20 years ago, SOGEBANK, the largest commercial bank in Haiti, embarked on its management-driven venture to enter the microfinance market. SOGEBANK cited several reasons for launching its service company, including low regulatory conditions, a reduction in the required legal reserve, and awareness of successful implementation by other commercial institutions. SOGEBANK was strategically positioned to enter this market because it held a significant share of savings from small savers and had developed capacity to process a high transaction volume. To reduce risk, SOGEBANK created SOGESOL as a joint venture with strategic partners. The first loans were disbursed to clients of SOGESOL in November 2000 (SOGESOL did not need its own bank license, avoiding arduous reporting requirements). Under the SOGEBANK-SOGESOL service agreement, SOGEBANK disburses all loans and maintains the loans on its books. For its loan origination and portfolio management services, a net fee is paid to SOGESOL representing the difference between all income accruing to loans originated by SOGESOL from interest and fees, and all costs and risks accruing to the managed portfolio, including loan loss expense, market cost of funds, a support service commission (contractual), and an ad valorem transaction fee. Besides credit, through similar arrangements with SOGEBANK, SOGESOL can offer its clients access to savings, payments, and remittance-related services. The service agreement has resulted in a microfinance portfolio of US$35.8 million (one of the largest in Haiti), and SOGESOL contributes to SOGEBANK's overall profitability, serving over 35,000 clients and generating a 15.3 percent return on investment.[24]

Case Study from Ecuador

Having decided that it wanted to expand its services to include microfinance and after careful consideration of the four models above, Banco del Pichincha (one of the largest commercial banks in Ecuador) selected the service company model and created CREDIFE in 1999. It did so because this model requires little capital and has a lean structure and a fast approval process. Clients of CREDIFE use Banco del Pichincha to make payments on their loans, as well to open saving accounts and conduct other banking transactions. In most cases, CREDIFE branches are inside the same building or close to Banco del Pichincha branches but they do not handle cash transactions. CREDIFE has its own policies on hiring, staff salaries, and incentives. It develops its own operating manuals as well as credit policies and procedures. Key factors in the success of CREDIFE include the existence of an internal champion in the bank. CREDIFE is currently the largest provider of microloans in Ecuador and one of the bank's most profitable units, with the value of CREDIFE's microfinance portfolio exceeding more than 10 percent of the total portfolio of Banco del Pichincha.[25]

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24 Mix Market data.

25 Mix Market data.

Annex III – Comparing the Lucrativeness of Service Companies versus Subsidiary MFIs

The following table compares the options from the perspective of a commercial bank between following a service company model or a subsidiary MFI model.

	Service Company	Subsidiary MFI
Regulations	In need of instructions and regulations.	In need of a waiver for lending to related party. In need of a separate banking license and control.
Capital	Lower requirement for minimal capital.	US$5 million, increasing over time when the company is overleveraged.
Funding/Financing	Access to plenty of low-cost financing.	Access to plenty of low-cost financing.
Cost Structure	Lower administrative costs: fewer administrative requirements as the commercial bank carries the liabilities and has to report on them.	MFIs' demanding administrative procedures and reporting requirements raise administrative costs.
Confidentiality	If the service company is owned by investors other than the commercial bank, the bank's clients' profile could be at higher risk of violating confidentiality.	MFIs control for confidentiality for their loans, and for their bank finances.
Transparency	No requirement exists for banks to show microfinance loans on their books.	Higher requirement for transparency.
Staffing	Administrative staff held at the bank, reduced reporting. Human resources are duplicated at the service company.	Duplication of staff at headquarters, and parallel human resources and IT departments.
Flexibility	As service providers with a focused operation and fewer reporting requirements, service companies are more flexible.	MFIs have their own bureaucracy.
Time to Start	Easier to start due to less licensing and administrative infrastructure. However, related regulations might require time to be issued.	Takes more time to set up due to administrative staffing and structure. However, the legal infrastructure (waiver) is faster to obtain.
Agency Issues	The service company's compensation scheme might incentivize agents to take riskier loans (this issue does not arise if the service company is fully owned by the commercial bank; in some cases, the service company also accepts to "guarantee" or buy back bad loans above a certain predetermined limit of arrears).	MFIs have different strategic goals.
Competition	Structure could lead to increased efficiency.	Compete on the same basis as other MFIs.

Annex IV: Instructions issued by the PMA relating to MFIs since 2011.

INSTRUCTIONS/ REGULATIONS	NO.
Presidential decree (132) on licensing and supervision the specialized lending institutions.	(132/2011)
Licensing specialized lending institutions.(later replaced with instructions (03/2016)	(01/2012)
Management of specialized lending institutions	(02/2012)
Regulation of housing loans and real estate financing based on the loan to ratio (LTV) standard	(01/2014)
loans Classification and provisioning	(02/2014)
Public Complaints	(01/2016)
Responsible finance	(02/2016)
Licensing specialized lending institutions.	(03/2016)
Working hours for specialized lending institutions.	(06/2016)
Financial and banking products, and their advertisement, and prize campaigns.	(01/2017)
Returned Checks, settlements, and stopped and lost checks	(02/2017)
Manual of Rules and Best Practices for Governance of Specialized Lending Institutions	(04/2017)
Loans that are scheduled, referred to the judiciary, restructured or refinanced, and write-off.	(01/2018)
Minimum disclosure requirements for audited financial statements	(02/2018)
IFRS 9 Financial Reporting Standards and Guidelines	(03/2018)
IT environment for specialized lending institutions	(04/2018)

Annex V: Example of tiered regulation

Title	Non Profit MFI	For Profit		Microfinance Bank	Commercial Bank	Notes
		MFI	Service Company			
	Non Prudential			Prudential		
Additional Products	Working Capital loans	Transfers Microinsurance		Deposits		Transfers Microinsurance Capital loans Deposits
Leverage	Starting at 1:1	Starting at 2:1	At the bank side	Starting at 5:1	Starting at 9:1	Given adherence to requirements institutions would be allowed higher leverage.
	Adherence to higher Requirements enables higher leverage					
	Could be eligible for 2:1 or higher	Could be eligible for 3:1 or higher		Could be eligible for 6:1 or higher	Could be eligible for higher in targeted sectors.	
Minimum capital (MM$)	$$	$$	$	$$$	$$$$	Higher minimum capital required with the evolving structure.
	Higher Minimum Capital					
Governance/ Staff Approval						Management signatures
Frequency of supervision	Annual	Annual	Annual	Semi Annual	Annual	Per year
Compliance	Higher Compliance					Higher compliance needed at each structure
Provisioning	More provisioning					More required Provisioning