Should banks in Palestine invest in microfinance market?

*Challenges & Opportunities*

Osama K. Najjar

Palestine

12/2009

Disclaimer: This study is prepared for academic & scientific purposes only and is not intended for investment or commercial purposes. The data and information contained in this study are taken from published sources so, the author does not bear any responsibility for any error or mistake stated in the study. All analysis and recommendations in the study reflect the opinion of the author only.

* Reproduction for educational and noncommercial purposes is permitted provided that the source is acknowledged.
Introduction:

In recent years, the interest in microfinance is growing increasingly in Palestine. Many studies prove that empowering access to finance for the microenterprise through MFIs or microfinance institutions is making significant contribution in poverty alleviation, job creation, empowering women and improve the communities.

After international financial crisis in 2008, the developing countries were less affected. But the foreign support to donors driven NGO’s is slowing down and collection of international capital becomes harder and more expensive. So, MFI’s couldn’t provide Microcredit market with all financial needs which makes the commercial bank may have an opportunity in these markets to cover the shortage. The problem is usefulness and profitability of microfinance market for the banks.

The reduction of foreign support to donors driven NGO’s is slowing down according to the international financial crisis.

Such as most of developing countries, Palestine is not out of the base. A lot of obstacles and limitations are facing the establishment of micro & small enterprises and these major obstacles summarized in: legal framework and regulations of Micro, small & medium enterprises (MSME’s), Access to finance, supportive services provided to MSME’s and infrastructure available for ME’s. (MAS, 2009).

Before starting to think if the banks should engage in microfinance market or not, which model is suitable to the bank and if it useful for the bank to invest in this market or not, the bank management must ask important question: Dose the bank have strategic vision to become major retail bank – Not corporate bank.

Is the bank has a strategic vision to become major retail bank or corporate bank?

A lot of challenges and obstacles faced the establishment process of Micro and small enterprises in Palestine. The Palestinian investment promotion law didn’t have any special exemptions or promotions for micro and small enterprises established in Palestine. On the contrary, the law encouraged the medium and large enterprises only with capital amount of 100.000 USD up to 1 million USD by more tax exemption which forces the existing small and micro enterprises to lose competitiveness advantage comparing to large companies.
Aim of the paper:
In this paper we will just have an overview about the Palestinian MFI’s performance, microfinance market size, advantages, obstacles and opportunities available for commercial banks in this market. By using some researches & references (referred in Page No 12) we will mention to some methods that helping the banks in entering the microfinance market and analyze the applicability of these methods for the banks in Palestine market.

What is Microfinance?
Microfinance is group of financial services such as credit, savings, cash transfers and insurance to poor or low-income people. It is powerful poverty alleviation tool, helps to increase household income, built assets, create demand for other goods and services, improve local economy (Visconti, 2009) and create job opportunities.

Key microfinance business challenges include (Roodman & Qureshi, 2006):
- Building volume.
- Keeping loan repayment rates high.
- Retaining customers.
- Minimizing scope for fraud in branches.

In Palestine, there is no formal definition for Microenterprises or for SME’s. It was and still there are significant differences of the definition of Mirco and SME’s in Palestine.

Internationally, the main criteria of MSME’s definition are: the number of workers, amount of sales, totals of assets, size of capital …etc.

The Palestinian authorities carry the responsibility to put suitable definition for it according to Palestinian conditions and specificity.

MFIs in Palestine?
In addition to other institutions concerned about microfinance market, The Palestinian network (PN) for small and micro finance is one of the most important network comprises 95% of microfinance institutions (MFI’s) in Palestine (BRANDSMA & BURJORJEE , 2004). It includes 9 MFI’s working in Palestine with net active loans about 45 Million US dollars.

Microfinance Market Size in Palestine:
No official surveys made in this field but according to some surveys made by Planet Finance in 2007 about the microfinance market in west bank and Gaza, the estimated number of microfinance market borrowers is 190,000 borrowers and the Palestinian
microfinance potential market size for micro lending services amounts of 280,000,000 USD.

Regarding to the sample of mentioned survey (1200 Micro entrepreneurs) 90.5% of Micro entrepreneurs have no access to credit services. 57% of sample is need for credit and 27% are not want credit for now but could be potential clients in the future. The requested loan amount is less than 2500 USD for a term up to two years.

In other estimations, the total estimated demand on credit by small and micro enterprises is about USD 80 Million annually. The MFI’s and NGO’s provide only 30 Million of it.

Regardless if these estimations are exaggerated or reflect the real demand, the Palestinian microfinance market is still young and not saturated.

**Financial performance indicators for Palestinian MFI’s :**

According to financial indicators report was issued by PN at end of March 2009 to measure the financial performance for 9 Palestinian MFI’s. The main important indicators are:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Q1/ 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Active borrowers</td>
<td>19,750</td>
<td>26,661</td>
<td>28,615</td>
</tr>
<tr>
<td>Net loan portfolio USD</td>
<td>26,860,000</td>
<td>43,976,000</td>
<td>46,263,000</td>
</tr>
<tr>
<td>Average disbursed loan size - USD</td>
<td>1569</td>
<td>2261</td>
<td>2400</td>
</tr>
<tr>
<td>Number of branches</td>
<td>60</td>
<td>68</td>
<td>69</td>
</tr>
<tr>
<td>Number of stuff</td>
<td>329</td>
<td>381</td>
<td>374</td>
</tr>
<tr>
<td>Number of stuff in credit &amp; front office operations</td>
<td>165</td>
<td>207</td>
<td>210</td>
</tr>
<tr>
<td>Number of loans per employee in credit</td>
<td>121 loans</td>
<td>129</td>
<td>136</td>
</tr>
<tr>
<td>PAR* &gt; 180 days</td>
<td>20.1%</td>
<td>10.6%</td>
<td>10.3%</td>
</tr>
<tr>
<td>Loan Loss reserve ratio</td>
<td>17.5%</td>
<td>10.8%</td>
<td>10.9%</td>
</tr>
<tr>
<td>Yield on Portfolio</td>
<td>11.5%</td>
<td>17.2%</td>
<td>19%</td>
</tr>
<tr>
<td>ROE **</td>
<td>-4.4%</td>
<td>+3.9%</td>
<td>+2.9%</td>
</tr>
<tr>
<td>ROA **</td>
<td>-4.1%</td>
<td>+3.4%</td>
<td>+2.4%</td>
</tr>
</tbody>
</table>

*PAR: Portfolio at Risk
** Excluding donations.
Competitive advantages of the banks:

If the bank decides to operate in microfinance market, it has several competitive advantages to draw upon comparison with MFI’s:

1- **Physical Infrastructure**: the banks often have network of branches & offices among the country and if these branches suitable for microfinance, it will cut the cost of opening new microfinance outlets. The existing other services such ATM’s, MIS, legal services, customer services, marketing dep., financial management will support and save the cost of microfinance operations.

2- **Human resources & Possibility to penetrate the market**: the banks have fleet of stuff in branches that know the local market very well and they can penetrate the microfinance market when they expand their activity.

3- **Capacity to create Specialized Unit**: the banks have the capacity to establish new specialized department or unit for Micro lending and provide the unit with stuff and provide them with kind of independence without stick with traditional polices & procedures.

4- **The existence & Brand recognition**: the banks existence in the market is well-known and have brand name even among lower income people with high degree of trust.

5- **Liquidity & availability of Funds**: most of banks already have access to local and international financial markets and have deposit base which provide the bank with all necessary funds for lending operations at low cost.

6- **Operating Cost structure**: the banks generally have lower operating structure cost than MFI’s with deferent degree from bank to bank.

Obstacles facing Banks in Microfinance:

1- **Information asymmetry**: the banks don’t have enough market knowledge and don’t understand this market as much as needed. In some cases, the bank management ignores this market as both too risky and too expensive without recognize that can be profitable.

2- **Credit Methodology**: the banks using specific method in traditional credit policy and try to adapt it with other retail, corporate and microfinance credit. If this methodology fail, they blame the idea of that microfinance is not promising market.

3- **Banks vision toward the technology**: the using of technology can reduce the cost of face to face transactions. The labor-intensive nature of microenterprises credit and using number of stuff for this new product may be undesirable for the banks.
4- **Conservative corporate culture**: the procedures, polices and the way of doing business in the banks may prevent the success of microfinance if it burdened with traditional polices and procedures.

5- **Human Resources**: Microfinance requires staff that are comfortable with the micro markets and its conditions with high productivity and monetary incentive systems. The policies of human resources in commercial bank incompatible with microfinance requirements.

6- **Small-scale lending cost and downscale problems**: the bank’s culture may move traditionally towards corporate or large lending scale. The stuff such as top management may feel uncomfortable with small & microloans and consider it as waste of time. They keep in mind the comparison between the amount of profit gained by large loans and these new small loans. And to start microfinance program in the bank you need some time to prepare, establish and start granting loans and to achieve the break even point and start to gain profit may it need time, which seem to the bank unprofitable program.

7- **Traditional view of Risk**: the banks traditionally look to the Microenterprises as too risky and too expensive even with or without evidences for that. May this point is part of point 1, 2 or 4 but the importance of this traditional view must be clear.

---

**Main obstacles facing the banks:**

- Information asymmetry of microfinance market,
- Small-scale lending costs,
- Downscaling problems,
- Traditional credit methodology used.

---

**The proposed methods of commercial banks entry into microfinance:**

From previous studies and some articles they suggested some methods for banks to enter the microfinance market and it may be suitable to be mentioned in this study:

1- **Internal Unit**:
Bank can create new unit or department for micro lending or even introduce the product through existing unit. But this method includes number of problems and rarely success. Some of disadvantages of this method are:

- **Top management commitment**: critical decisions for microfinance operations made by top management with limited concern for microfinance. Senior decision makers in banks may not convince in microfinance in their bank strategy, one or two of senior managers may be encouraged to microfinance but the others look at this idea as distraction.
- **Governance**: some studies argued that microfinance unit must have independent governance and without separate governance the microfinance unit will fall under the governance of mother bank.
- **Bank Culture**: microfinance has specialty in implementation and conditions. Banks must differentiate between the mainstream of stuff and the stuff of microfinance unit to built distinct corporate culture.
- **Bank Stuff problems:** the rotation of employees or mobile the mangers to microfinance unit may be viewed as bad career move. Microfinance unit part of larger structure and the management rotation policies can result in frequent changes, including the placement of employees with low knowledge or less interest in microfinance.

On the other hand, this unit can be successful if the above obstacles solved. If the bank create Micro lending unit and making good choice in hiring expert manager in this field and allow to him with his unit stuff to create separate culture, independent governance, separate strategy of unit, avoid traditional policies and procedures in the mother bank, create new suitable procedures and independent authority to make decisions the unit chances to success is very high.

Fortunately, the other supportive units, services and departments in the bank will be helpful in success of microfinance unit. The low cost of overhead for the unit and existing branches and outlets are factors in reducing the cost and increase the profitability for this unit.

2- **Financial Subsidiary:**
Such as brokerage firms established by some banks, the financial subsidiary establishment to serve microfinance industry may be good idea. It may attractive for some bankers to avoid distributing the operation of bank. In crating subsidiary, the bank limits its risk of entry microfinance market by sharing other investors and other shareholders with needed experience in this market. And by creating independent entity, the bank ensures that the new firm will stick in its objectives and goals. But the regulations and legal framework vary from country to other. It requires its own equity capital base and need to create separate stuffing structure, management and governance. Strategic decision must be made by the bank to put capital in this subsidiary.

3- **Purchasing shares or equity:**
One of method to entry the microfinance market is to purchase shares or equity in existing microfinance institution who already serve this sector. This way could save efforts to establish financial subsidiary or creates internal unit.

The investing in existing microfinance institution may be good regarding to its knowledge in market and already having all necessary supportive services, human resources… etc.

The maim problem of this choice is which institute could the bank invest in. most of MFI’s are NGO’s or non-profit organizations which be unsuitable for investment purposes or facing legal problems with this form of institutions. And the commercial institutes must be analyzed carefully before the investment decision is made.

4- **Lending for MFI’s:**
It is the simplest way to invest in this market. Many banks around the world are already lending to MFI’s. But if the leverage increases for weak MFI will increase the default risk for the bank.
5- **Strategic alliance:**
It is rare in fact, but the bank can create complex alliance with existing MFI by making an agreement to allow the MFI to carry out the credit approval, administration and follow up of the borrowers and let the bank to do the funding mission and transactions processes in the bank.

The bank could take the advantage of market knowledge and credit methodology of MFI. And it doesn’t force the bank to make operational changes or significant investment.

6- **Service Company Model:**
This new effective model allow to the bank to establish Non-financial service company that provides the bank with all loans origination, credit administration, promotion, evaluating, tracking and collecting the loans.

In return, the company is paid a fee by the bank. This company employs loan officers and microfinance program stuff to provide the bank with all services. In the same time the company will benefit from the bank in teller services, using ATM’s, human resources and technology services.

This service company could be fully owned by the bank or with additional investors.

Legally, a service company is a variant of the subsidiary model with the crucial distinction that it is not a financial institution. A non-financial 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.

**What is the most convenient method in Palestine?**

If we attempt to apply one of the above methods in Palestine, may we will face some challenges regarding to special conditions in Palestine.

In fact, most of the problems mentioned in each method exist in Palestinian banks case.

- **Internal unit:** with all problems and obstacles mentioned above, In Palestine case the success of internal unit depending on:
  1. The Key of internal unit successful is to give the unit the autonomy and independent. The bank’s top management must allow the unit to create its separate polices and procedure and avoid the traditional procedures followed in the bank.
  2. The unit must create its separate culture with specialized stuff in microfinance to increase their commitment and avoid the mainstream stuff in the bank.

The Key of internal unit successful is to give the unit the autonomy and independent. The bank’s top management must allow the unit to create its separate polices, procedures and culture.
3- Allow to the unit to benefit from all available services in the bank such as all supportive and operational dep., ATM, technology, legal services.
4- The bank must don’t apply the existing credit methodology on this unit. The banking credit policy and methodology in most cases doesn’t apply to micro lending. But the mother bank can put some guide line.

- Financial Subsidiary: this method may be not preferred for the bank in Palestine. A lot of legal and regulations concerns may face the establishment of the subsidiary. The need for separate equity and the costs need for strategic decision in the bank. The benefits for the bank are:
  1- This method allows to bank to enter the microfinance market with limit risks and may share with other investors.
  2- Don’t disturb the bank operations and avoid all problems related to create internal unit.
  3- Create separate culture, polices and procedures in the subsidiary.
  4- The subsidiary could benefit from bank services and vise versa.

We can summarize the advantages of each one by the following table:

<table>
<thead>
<tr>
<th>Advantages of an Internal Unit over an External Organization</th>
<th>Advantages of an External Organization over an Internal Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Can be faster to start up</td>
<td>The bank’s losses are limited to the amount it has invested in the external organization</td>
</tr>
<tr>
<td>Can have lower operating costs</td>
<td>Image and branding</td>
</tr>
<tr>
<td>Greater freedom to do microlending right</td>
<td>Allows outside shareholders to be incorporated. These shareholders can contribute to governance, provide capital and technical assistance, and reduce risks for the bank</td>
</tr>
<tr>
<td>No restrictions on loan portfolio funding. These restrictions can eventually limit the expansion of the microlending program and drive up the cost of acquiring loanable funds</td>
<td>Don’t disturb the bank operations and avoid all problems related to create internal unit.</td>
</tr>
<tr>
<td>Stuff, unit management, policies &amp; strategies could be fully controlled by the bank</td>
<td>The subsidiary could benefit from bank services and vise versa</td>
</tr>
</tbody>
</table>


- Purchasing Shares or equity: Most of MFI’s in Palestine are NGO’s and non-profit organizations. The application of this method is inapplicable in Palestine.

- Lending to MFI’s: it is a simplest method applicable in Palestine. But still very tied and limited because:
  1- Obstacles of legal framework of MFI’s.
2- Very limited number of MFI’s has creditability for commercial loans.

Lending to MFI's is a simplest method applicable in Palestine. But it is still very tied and limited.

- **Strategic alliance**: if the would like to apply this method, the bank must has high level of trust of the MFI. In Palestine, many of MFI’s are unsustainable financially and the performance indicators are not encourageable.

- **Service company model**: May it is useful method in Palestine to avoid all problems of subsidiary establishment, internal unit and alliance. But still have a problem in costs and the strategic decision to establish the service company with new capital and equity.

Theoretically, Establishment of Service Company is the most applicable method in Palestine. But No practical evidence to prove its success.

We can summarize the advantages for the financial subsidiary & Service company model by the following table:

<table>
<thead>
<tr>
<th>Advantages of a Service Company</th>
<th>Advantages of External Subsidiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Easier and less costly to launch and operate than a financial subsidiary. Eliminating initial tasks, start-up cost and often start-up time with respect to heavily regulated subsidiaries.</td>
<td>Greater autonomy in certain limited spheres including, for heavily regulated subsidiaries that has the chances to offer more appropriate services and products</td>
</tr>
<tr>
<td>Does not require a large equity base.</td>
<td>Can reduce the risks to the bank of the micro lending operations.</td>
</tr>
<tr>
<td>Greater integration into the bank reduces operating costs.</td>
<td>Subsidiary may have more favorable treatment than an internal unit or even a service company</td>
</tr>
<tr>
<td>Funding advantages: a) greater availability and less uncertainty about the availability of loan portfolio funding and b) lower funding costs</td>
<td><strong>Disadvantages</strong>: Limited Fund, High operating cost, start up costs, legal issues and may large equity base.</td>
</tr>
<tr>
<td>A non-financial company does not require a separate banking license, is not separately supervised by the banking authorities</td>
<td>-</td>
</tr>
</tbody>
</table>

Conclusion:

The microfinance market is huge and potential market with limited penetration of MFI’s working in Palestine. The estimations refer to at least 80 million USD annually is the financing needs in microfinance market in Palestine, existing MFI’s cover only less than 30 million USD.

The banks in Palestine have competitive advantages in respect to existing infrastructure, technology, human resources, supportive services, high capacity and huge available funds in banks comparing to MFI’s.

The banks face some obstacles in entering the microfinance market such as information asymmetry about this market, existing credit methodology, labor intensive, small-scale lending costs… etc.

The most applicable methods in Palestine to enter the microfinance market are:

1- Create internal unit in the bank. A lot of obstacles and problems with this method and the bank must deal very carefully with this method to solve these problems to avoid the failure.
2- Lending to MFI’s directly. But this method is very limited and conditioned. And in fact, it doesn’t have any value added to the economy.
3- Establishment of Service Company. This method is the most applicable method in Palestine theoretically. Need for capital and costs but has a lot of advantages with minimum disadvantages. No practical evidence in Palestine to prove its success.

The other methods are could be applicable but the success depends on the way of implementation and application of these methods in effective way to achieve the desired targets and goals.

The micro businesses need for more than loans, and the needs for comprehensive multi-financial services makes the banks are more compatible place for them. In the same time, the banks have opportunity to serve these needs in profitable way.

Should the Palestinian banks invest in Microfinance?

The current poor performance of MFI’s in Palestine does not reflect the potential that a profitable market does in fact exist. All the methods mentioned above could be applied in different ways with different levels of success but the trick is in which method and how to enter this market effectively. Banks should determine what targets and goals to establish, select the right clusters and sectors, create a retail strategy and choose the optimal method to enter this market in effective ways.
Main References & recommended to read:


Disclaimer: This study is prepared for academic & scientific purposes only and is not intended for investment or commercial purposes. The data and information contained in this study are taken from published sources so, the author dose not bear any responsibility for any error or mistake stated in the study. All analysis and recommendations in the study reflect the opinion of the author only.

* Reproduction for educational and noncommercial purposes is permitted provided that the source is acknowledged.
For additions, comments and inquiries please send to:

Osama K. Najjar
EPCGF – Palestine +972599321540
o_najjar@hotmail.com