PN-ACA-531
93849

MICROENTERPRISE FINANCE SECTOR ASSESSMENT

OF

THE WEST BANK AND GAZA

(FINAL REPORT)

PREPARED FOR:
THE USAID WEST BANK AND GAZA MISSION

BY:

Stephen C. Silcox, Team Leader
Karl F. Jensen
Olaf E. Kula

CONTRACT NUMBER
HNE-0159-C-00-3080-00

FEBRUARY 1996

MSI
MANAGEMENT
SYSTEMS
INTERNATIONAL

600 Water Street, S.W.
Washington, D.C. 20024
USA

202/484-7170
Fax: 202/488-0754

ACKNOWLEDGEMENTS

This assessment has been an extremely interesting and challenging assignment for both the MSI consultant team and USAID staff. The situation in the West Bank and Gaza is a very unique political and economic environment in which to address the issues involved in microenterprise development. Although the basic principles of microenterprise finance apply universally to the creation and sustainability of microfinance institutions, they must be made to fit the specific conditions in each country or environment. The team has attempted to fulfill this task in this assessment.

We owe much to various individuals and organizations in the completion of this task. Firstly, we would like to thank USAID/WB/G for their interest and support in conducting this assessment. Special thanks go to Brad Wallach for his vision and total involvement in the design and conduct of this assessment. Salah Abdel Shafi was invaluable for his knowledge of local groups and institutions and his advice on the potential for microenterprise development support in the local context. Theodora Hindeleh's able assistance with critical logistical assistance was much appreciated. We would also like to thank all of the senior staff of the USAID mission and the Economic Officers at the U.S. Embassy in Tel Aviv and the Consulate General in Jerusalem for their interest and ongoing guidance during the process of this assessment.

Secondly, we would like to thank the representatives of the various NGOs, financial institutions, projects, and international donors for their information on existing activities supporting small and microenterprises and potential for further activities. Their insights were crucial to the recommendations for the design of a microenterprise finance project for USAID.

Thirdly, we would like to express our appreciation to Elisabeth Rhyne, Director of the Microenterprise Development Office in the Global Bureau of USAID Washington, for her interest in this mission and her indispensable advice. She provided the team with suggestions on the conduct of this assessment prior to our departure from Washington, DC, and travelled to Tel Aviv to be present at the final team debriefing to USAID/WB/G. Her detailed and insightful comments on the draft report were most helpful and contributed to a much improved final report.

Stephen C. Silcox, Team Leader
Washington, DC
February 26, 1996

LIST OF ACRONYMS

ADCC	Arab Development and Credit Company
ANERA	American Near East Refugee Aid
CD	Cooperation for Development
CHF	Cooperative Housing Foundation
EDG	Economic Development Group
JD	Jordanian Dinar
LPG	Loan Portfolio Guarantee Program
MFI	Microenterprise Finance Institution
MSI	Management Systems International
NGO	Non-Governmental Organization
NIS	New Israeli Shekel
PA	Palestinian Authority
PDF	Palestinian Development Fund
PMA	Palestinian Monetary Authority
PVO	Private Voluntary Organization
ROSCA	Rotating Savings and Credit Association
SCF	Save the Children Foundation
TA	Technical Assistance
TDC	Technical Development Corporation
UNRWA	United National Relief and Works Agency
USAID	United States Agency for International Development
WB/G	West Bank/Gaza

Approximate Exchange Rates in February 1996

US$1 = NIS3.06
US$1 = JD0.67

c

DEFINITIONS

(These definitions are taken from the USAID Microenterprise Policy Directive. Many of these terms are used throughout the text of this report.)

Adjusted return on operations - The core measure used by USAID to assess the financial sustainability of a microfinance institution. A value of "one" or greater implies full financial sustainability.

Arrears - The value of interest and principal payments owed but not paid on a delinquent loan.

Broad outreach - The provision of significant benefits to large numbers of a particular target group.

Character and/or experience-based loans - A form of collateral substitute in which the initial loan is very small, but access to gradually increasing loans is assured as long as the borrower maintains a satisfactory repayment record.

Collateral substitute - A mechanism for ensuring the repayment of loans other than the provision of formal collateral by the borrower. In the context of microfinance, group lending and character-based (experience-based) lending are the most common forms of collateral substitutes.

Deep outreach - The provision of significant benefits to particularly disadvantaged members of a broader target group. In the case of microenterprise development programs, these typically include the poorest microentrepreneurs, female microentrepreneurs, etc.

Delinquency - The failure of a borrower to make interest and/or principal payments on time. A delinquent loan is one on which payments have not been made on time.

Delinquency rate - The total outstanding principal on loans with payments past due more than a given number of days, as a percent of a financial institution's average loan portfolio (average unpaid balance on outstanding loans.) In the context of this guidance, 90 days past due is used as the threshold of delinquency.

Financial costs - The costs of the funds raised by a microfinance institution to cover its lending. Depending on the context, this may include only out-of-pocket interest costs paid to depositors and/or to other financial institutions, or may include as well the opportunity cost of funds received as grants or soft loans from donors, governments, or charitable organizations.

Financial regulation(s) - the set of rules governing the conduct of financial institutions.

D

Financial services - In the context of microenterprise development, includes the provision of loans, the acceptance of savings deposits, and payments services such as the provision or cashing of money orders, and other similar services useful to low income people.

Financial supervision - The examination and monitoring of financial institutions -- usually by government authorities -- to ensure compliance with financial regulations.

Financial sustainability - The degree to which an organization collects sufficient revenues from sale of its services to cover the full costs of its activities, evaluated on an opportunity-cost basis.

Forced savings - Savings deposited in a microfinance institution as a condition of eligibility for receiving loans. Distinguished from voluntary savings, which are deposited independent of such a condition.

Full-cost-recovery interest rates and fees - the level of interest rates and fees needed to cover the full long-run costs of providing a given loan.

Full financial sustainability - A situation in which the revenues an organization generates from its clients cover the full (opportunity) costs of its activities, thus allowing it to continue operating at a stable or growing scale without ongoing support from governments, donor agencies, or charitable organizations. When applied to a microfinance institution, full financial sustainability requires that the interest and fees the MFI collects on its lending equal or exceed the sum of its operational and financial costs, with the latter evaluated on an opportunity-cost basis.

Group lending - A form of collateral substitute in which borrowers form groups, all of whose members must maintain a satisfactory payment record for any group member to be eligible for future loans.

Implementing organization - In the context of microenterprise development, any government or non-government organization that directly provides financial services and/or non-financial assistance to microenterprises, or that performs other activities intended to improve the environment for microenterprise performance.

Loan loss rate - The total principal on loans written off as uncollectible during a particular reporting period, as a percentage of the average unpaid balance on outstanding loans over the same reporting period. In the context of this guidance, all loans past due one year or more must be written off as uncollectible;

E

institutions may set stricter standards.

Market test - The principle that the value that people attach to any goods or services provided to them must be at least equal to the amount they are willing to pay for those goods or services.

Median - The middle value in a distribution. As applied e.g. to the loan portfolio of a microfinance institution, calculated by arranging its loans from smallest to largest and observing the value of the loan in the middle of that distribution.

Microenterprise - A very small-scale, informally organized business activity undertaken by poor people; excludes crop production by convention. For USAID program purposes, the term is restricted to enterprises with 10 or fewer workers, including the microentrepreneur and any unpaid family workers.

Microenterprise development - Any activity undertaken by donors, host-country governments, or non-government organizations to improve the lives of poor people by encouraging the formation of microenterprises and/or the improved performance of existing microenterprises. Also, the overall process of improvement in the performance of microenterprises.

Microentrepreneur - the owner-operator of a microenterprise.

Microfinance - the provision of financial services adapted to the needs of low income people such as microentrepreneurs, especially the provision of small loans, the acceptance of small savings deposits, and simple payments services needed by microentrepreneurs and other poor people.

Microfinance development - A subset of microenterprise development efforts, focusing on extending and strengthening microentrepreneurs' and other poor people's access to appropriate financial services.

Microfinance institution or organization - An organization whose activities consist wholly or in significant part of the provision of financial services to microentrepreneurs. Abbreviated MFI or MFO.

Non-financial assistance - In the context of microenterprise development, any effort undertaken to improve the performance of individual microenterprises or of microenterprises as a group other than through microfinance. Includes, but is not restricted to: training of individual microentrepreneurs; efforts to link microenterprises with suppliers or markets for their output; the development and extension of technologies for use by microentrepreneurs; and lobbying efforts for improvements in policies and/or institutions affecting microenterprises.

F

Operational costs - That portion of a program's costs that cover personnel and other administrative costs, depreciation of fixed assets, and loan losses.

Operational efficiency - the extent to which an organization succeeds in minimizing its operational costs, given the target population with which it is working. Measured by the ratio of the organization's operational costs to the average value of its outstanding portfolio.

Operational self-sufficiency - A situation in which an organization generates sufficient revenues from clients to cover all of its operational costs.

Opportunity costs - In general, the value of a given set of resources in their best alternative use. As applied to a microenterprise development program, refers to the market value of the resources used to carry out that program. In particular, calculating the opportunity costs of a program requires that any funds or other resources received in the form of grants or low-interest loans be evaluated according to what the institution would have had to pay for those funds had it raised them in private financial markets.

Poverty lending - A subset of microfinance program efforts which use very small loans to reach very poor clients, often with a focus on women for operational purposes, USAID uses a reference point of loans with an average balance less than the local-currency equivalent of US$300 per borrower at 1994 prices as a working definition of poverty lending.

Prudential financial regulation - The subset of financial regulations intended to contribute to the stable and efficient performance of financial institutions, including the protection of depositors' assets.

Subsidized credit - The provision of loans on the basis of interest rates and fees that fail to cover the full long-run costs of providing those loans.

6

TABLE OF CONTENTS

H

ANNEXES

I

EXECUTIVE SUMMARY

Purpose

The purpose of this study is to assess certain key aspects of the microenterprise sector and its environment in the West Bank and Gaza in order to provide USAID with sufficient information and options to plan for and design a new project activity in microenterprise finance.

Areas Researched and Analyzed

This assessment required research and analysis in the following areas:

- Review of the existing financial sector environment for microenterprise finance,
- Analysis of the principal programs currently providing microenterprise finance,
- Review of the other relevant credit programs and non-financial support programs for small and microenterprises,
- Examination of the economic and cultural environment affecting small and microenterprise development,
- Assessment of the demand for microenterprise finance and demand elasticity factors and the potential for increased employment resulting from microenterprise finance assistance, and
- Review of best practices in microenterprise finance in other countries.

This consultancy took place over a five week period from early January to mid-February 1996. Visits were made by team members to both Egypt and Jordan to interview officials from other microenterprise lending programs there. Lessons learned from those programs were incorporated into the analysis for this assessment.

Summary of the Current Conditions of the Banking Sector

The banking industry, like much of the formal economy of WB/G, is in a state of flux and growth. Most of the banks currently operating in WB/G have intentions of opening other branches to capture more deposits. Most Israeli-owned banks have withdrawn from the WB/G areas. One notable exception is the Israeli-owned, Mercantile Discount Bank which has recently been granted a license by the PMA to operate in Bethlehem, but has not yet reopened. Banks operating in the area now are primarily Jordanian-controlled, but three Palestinian-owned banks are currently in operation. There has been a tremendous increase in the number of banks and bank branches. Numbers have exploded from 2 banks with 10 branches at end of 1993 to 12 banks with over 50 branches at end of 1995.

Banks provide two important services to the community; savings collection and loan provision. While the banks in the WB/G do provide both services, the balance is severely skewed. Total deposits exceed one billion US dollars equivalent (liabilities), and loans (assets) are approximately $220 million. There has been an apparent "mopping up" of savings from both residents and deposits from Palestinians overseas, but there has yet to be extension of lending within the area now controlled by the Palestinian Authority. To this point in time, no firm decisions have been made on local reinvestment of deposits; generally funds held by Jordanian-owned banks are reinvested in government securities in Jordan or held to cover transactions with Israeli entities through Israeli correspondent banks.

There is currently a broad range of bank branches providing services in WB/G. However, there are precious few examples of banks lending to small and micro enterprises. Lending practices are conservative, with most loans being for overdraft facilities (roughly 72%), closely followed by term loans of 1-3 years (over 23%). The formal banking sector is at least as conservative as the parent banks in the region. On the surface, lending is based on liquid collateral (cash), but underpinned by "name" lending. Wealthier families with businesses recognized within the banking community have far greater access to banking services than poorer, less well known clients.

Overview of Microenterprise Credit Programs

All of the NGO programs investigated have gone through considerable change in their methodologies in the last two years. Some, like UNRWA and SCF, have reached down to poorer borrowers in their lending portfolios, whereas others like the Economic Development Group and the Arab Development and Credit Company have decided to abandon their microenterprise lending activities and move upmarket to serve small and medium scale enterprises.

Several NGOs have recently launched programs that issue relatively small loans (initial loans in the USD 200-300 range)for short terms (4-6 months) using internationally accepted microenterprise lending methodologies. These programs have been particularly successful at reaching women.

The portfolio performance of most of the NGOs lending to microenterprises has improved in the last couple of years due to several factors. Much NGO credit granted during the Intifada years was either granted or perceived as relief assistance, not as payable debts. Under Israeli military occupation, loan contracts were not enforceable, making recovery in the case of borrower default very difficult. (This has since changed, however, under policies by the Palestinian Authority after the Peace Process. Legal procedures recently adopted allow for relatively rapid action on unpaid debts.)

All of the NGOs still serving microenterprises have adopted improved and cost efficient technologies for lending, reducing or eliminating the need for collateral, and using solidarity groups or other forms of moral security and character based lending.

All of the microenterprise lending programs visited are too new to accurately assess their performance. UNRWA, SCF and CARE include reaching operational self-sufficiency as one of their targets for the next two to five years. None are close to covering their operating costs given the size of their loan portfolio and the interest rates being charged. Under optimal conditions, SCF and UNRWA could cover all of their operating costs in the next few years, assuming significant portfolio growth.

Informal Financial Services

Informal sources of finance are still the most important suppliers of short term credit. The majority of microenterprise financing in the WB/G comes from personal savings, remittances and family. Financing from informal credit makes up the next largest source of financing for microenterprises. Informal sources include supplier credit, formal and informal money changers, and informal rotating savings and credit associations called *jamiiyaa*. The effective interest rate for informal, short-term microenterprise loans ranges from 60% to 300% annual [UNWRA, 1996].

Economic and Cultural Environment

Political and economic uncertainty has had substantial impact on the microenterprise sector. Border closures, decreases in work permits, and other restrictions on the free movement of people and goods have increased instability in the market and sector. However, their negative impact on microenterprise development is considerably less, on balance, than upon small and medium enterprises. Cultural factors regarding interest-based lending and women entrepreneurship appear surmountable. Some problems have occurred in both the UNRWA and STC programs, but innovative methodologies have been employed to overcome them. Many women appear to be operating microenterprises due to family dislocations and the harsh economic environment.

Estimated Size of the Microenterprise Sector

There is a paucity of current data on microenterprises in the WB/G. However, estimates indicate that there are currently about two million residents in WB/G. Of that population, one half (those over 16 years of age) are assumed to be employable. About 35% of the total employable population is unemployed, but 25-30% of the employed population is reported as self-employed. Using this category of persons as a proxy for possible microentrepreneurs, the total microentrepreneurs in the WB/G would be conservatively estimated to number at least 150,000. Based on information available from other sources, approximately 90% of existing private businesses in the WB/G have less than ten employees and at least 80% of existing businesses have less than 5 employees.

Working Definition of Microenterprises in WB/G

For the purposes of a potential USAID-financed microenterprise finance project, a "microenterprise" could be defined as a business with ten or less employees. This is consistent with the USAID worldwide definition of microenterprises and applies broadly to the situation in WB/G. One could further refine the operational definition for a proposed microfinance project, however, by providing special emphasis on existing businesses with less than five employees and with capital requirements of less than $10,000.

Assessment of Demand and Demand Elasticity

Over 80% of all enterprises in the WB/G employ fewer than five people. Based on the calculations on census data in the last section of this chapter, we estimate a minimum of 150,000 microenterprises in the WB/G. If we assume that only 10% of the microenterprises in the WB/G would be eligible and interested in accessing a microenterprise loan (a conservative assumption), demand would still be 15,000 borrowers. Given that there are fewer than one thousand microenterprise loans made in all of the WB/G today, it is reasonable to assume that there is a considerable "credit gap" at interest rates sufficient to cover the costs of microenterprise lending.

If sustainable access to credit is the objective, demand elasticity is secondary in importance to the determination of what it will cost to deliver microenterprise loans. In this scenario, the market rate of interest becomes largely irrelevant. In fact, in most developing societies, there is no market rate of interest for microenterprise credit, because there is no formal market for microenterprise credit. Regardless of what other markets charge, no microenterprise credit facility can ever become sustainable unless it can cover all of its costs, including bad debt loss and profit, through its fees or interest rates.

On the other hand, once an interest rate based on real costs to the credit facility of delivering credit has been set, it then becomes important to determine whether sufficient demand exists at that level. Because most microenterprises have no alternative sources of credit at rates below the cost of informal credit (60%-300% in the WB/G), demand elasticities are not a realistic concern for a proposed USAID-financed microenterprise finance project.

Potential for Increased Income and Employment From a Microenterprise Finance Facility

Financial services for microenterprises are much more likely to

M

increase the incomes of microentrepreneurs and reduce underemployment. In an environment where a microenterprise is often the only alternative to unemployment, income enhancement is the more important objective. Extensive, multi-country, GEMINI studies of the growth and dynamics of microenterprises indicate that only a small percentage of microenterprises expand to employ over 10 people.

Rationale for USAID Involvement in Support of Microenterprise Finance

- A microenterprise finance project has the potential for immediate impact on low-income Palestinians through increases in income and business expansion.

- A microenterprise finance project would help to create local, sustainable institutions to provide long-term development through a local source of finance for microenterprises.

- A microenterprise finance program helps to develop the private sector from the bottom up.

- USAID has a comparative advantage over other donors in microenterprise finance and extensive worldwide experience which would be brought to bear on any project in WB/G.

- Most other donors in WB/G are not active in the area of microenterprise development and have expressed little interest in funding any microenterprise finance activities. Many have recognized USAID's comparative advantage in this field and are looking to USAID to develop local institutional capacities in this area.

Program Options and Recommendations for a Microenterprise Finance Project in the West Bank and Gaza

Recommended Target Group Attributes

- All microenterprises in the WB/G should be eligible to participate in any USAID funded microenterprise lending program.

- Eligible microenterprises should include all enterprises with 10 or fewer employees with a priority given to those enterprises with 5 or fewer employees.

- Program design and implementation should ensure women's access to financial services.

- Only established microenterprises should be eligible for loans.

N

Recommended Financial Products

- Short term working capital loans should be the foundation of the microenterprise finance intervention.
- Loan amounts should be incrementally increased for repeat borrowers.
- Repeat borrowers should be able to access medium-term investment capital, after demonstrable good repayment on working capital loans.
- Microfinance program clients should, at a minimum, be encouraged to save a regular amount at periodic intervals.

Lending Methodologies

- Loans should be made to individuals.
- Lending should be based on character and peer guarantees rather than collateral.
- Linkages should be made with banks to ensure sustainable access to adequate loan funds.
- Interest rates should be set high enough to cover all lending costs as the microenterprise finance institution reaches scale, after a reasonable start-up period.
- Any client training should be limited to what is necessary to ensure efficient operation of the lending mechanism.

Legal and Policy Framework

- The Palestinian Monetary Authority, while formed, is not yet in a position to exert supervision or control over the banks operating within the WB/G. There are not yet any formal rules or regulations guiding NGOs or banks in microfinance.
- USAID should monitor PMA actions that would affect the microfinance market. USAID should work closely with those organizations and donors advising or promoting policy changes through the PMA.
- USAID should establish and maintain close contacts with key officials in the PMA and involve them in any educational or informational activities to promote microfinance.

Recommended Institutional Strategy

Given the newness of microenterprise finance in the WB/G, USAID should keep all three options open - funding pioneer activities by existing NGOs, engaging the banks to broaden their loan portfolio downward, and identifying a possible hybrid organization. This is consistent with the approach espoused by the Microenterprise Development Office of the Global Bureau and recognizes the dangers of placing too much faith in the commercial banking sector to take prime responsibility to develop a microenterprise finance program as a long-term option.

The project would provide support to various alternative institutional vehicles, depending upon the results achieved during Phase I. At the end of Phase I, USAID/WB/G should evaluate the performance of the NGOs receiving assistance during Phase I and determine the indicated level of continued support. Concurrently, one or more commercial banks should have been identified for the development of a microenterprise finance facility. If there were no interest by a commercial bank in the establishment of a microfinance facility, the Mission would consider a possible hybrid organization. At that point, the Mission would determine the most effective means of creating that hybrid organization, including the issuance of an RFP that would specify the type of hybrid organization desired. The RFP would request proposals from various firms and NGOs on how they would go about creating that organization and implementing a microfinance program.

Programming Strategy

The Sector Assessment Team recommends that USAID implement a two-phase program. The first phase would begin immediately and run approximately one year. The second phase would run for four years at the end of the first phase.

The major activities of Phase I would be:

- Funding for the expansion of a maximum of 3 existing NGO microfinance programs;

- Engagement of the formal banking sector to assess interest in a microfinance facility and to identify individuals either in the banking sector or the business community who might be interested in championing the creation of a microenterprise finance program;

- Conducting a seminar for key individuals in the banking, NGO and business communities who are interested in the concept of microfinance; followed up by visits to successful programs in other countries for those individuals who demonstrate the most interest in microfinance during the seminar;

- Technical assistance to banks or others who are interested in developing a microfinance program and to NGOs who may have received grants for expansion of their programs, and

P

- Exploration of the feasibility of an alternative, hybrid organization which could implement a microfinance program.

The major activities of Phase II would be:

- expansion of financial services,
- participation by a commercial bank or a hybrid organization,
- finance of continued short-term technical assistance to selected NGO-run MFIs,
- continued capitalization of loan or guarantee funds of well-run MFI programs, if necessary,
- financial support of program start-up costs for financial institutions committed to a microfinance facility, and
- long-term technical assistance and training for facilitating the development of a microenterprise program run by a commercial bank or a hybrid organization, designing and implementing training programs and short-term TA, and monitoring project progress by both banks and NGOs.

Non-Financial Services

Assessment of non-financial constraints to microenterprise growth is proposed for some time in year three of the proposed activity. A subsector assessment of 1-3 key subsectors that engage large numbers of microenterprises is proposed. Based on this assessment USAID would determine whether and what type of non-financial intervention is indicated.

Training and Technical Assistance

During Phase I, project training and technical assistance would be largely short-term. Mission staff would contract with firms to conduct a microfinance workshop and study tours. Mission staff would be responsible for the identification of potential banks or hybrid organizations for participation in the creation of a microfinance facility during Phase II.

Should the creation of a microfinance facility in a commercial bank or a hybrid organization prove to be viable, it is recommended that the Mission contract for long-term assistance to guide the process of developing the methodology of microenterprise lending with the bank(s)/hybrid organization selected and guiding the process of the development of microfinance capacity within the institution. This long-term contractor would identify and facilitate short-term TA and training for both the bank(s) and NGO(s) as required. The contractor would also be responsible for project monitoring and assuring that USAID reporting criteria are fulfilled.

CHAPTER ONE

INTRODUCTION

A. Context of the Assessment

Purpose

The purpose of this study is to assess certain key aspects of the microenterprise sector and its environment in the West Bank and Gaza in order to provide USAID with sufficient information and options to plan for and design a new project activity in microenterprise finance.

Background

As a result of frequent border closures and other factors, unemployment in the West Bank and Gaza (WB/G) exceeds 30 percent of the workforce. Underemployment is similarly endemic. Industrial capacity utilization is less than 60%, on average. GDP per capita has declined, in real terms, since 1987.

This deterioration of the economic environment has forced many displaced workers into the informal/microenterprise sector. Although very little census or survey data exists to quantify the magnitude of the microenterprise contribution to the economy of the territories, empirical evidence suggests that such enterprises make up a significant, and growing, portion of GDP.

There is no tradition of microenterprise lending within the formal banking system in Gaza or the West Bank. Two donor-assisted programs currently offering microenterprise credit (Save the Children Federation and UNRWA) report high demand and recovery rates. Based on this limited experience, it is assumed that the supply of microenterprise credit is far below the latent demand.

The development hypothesis for a potential microenterprise project design is, therefore, that enhanced access to credit for microentrepreneurs will stimulate significant economic activity, alleviate poverty and create employment.

Areas Researched and Analyzed

This assessment required research and analysis in the following areas:

- Review of the existing financial sector environment for microenterprise finance,

- Analysis of the principal programs currently providing microenterprise finance,

- Review of the other relevant credit programs and non-financial support programs for small and microenterprises,

- Examination of the economic and cultural environment affecting small and microenterprise development,

- Assessment of the demand for microenterprise finance and demand elasticity factors and the potential for increased employment resulting from microenterprise finance assistance, and

- Review of best practices in microenterprise finance in other countries.

Types of Recommendations Presented

Based on the above research and analysis, the MSI team makes recommendations in this report that cover the following topics:

- Attributes of the target groups to be addressed by a proposed microenterprise finance project,

- Alternative potential institutional arrangements for microenterprise finance delivery systems, drawing upon lessons learned in the implementation of similar programs in other development contexts,

- Types of financial products and lending methodologies to be employed,

- Monitoring and evaluation issues,

- Training and technical assistance needs to implement a proposed microenterprise finance project,

- Rationale for USAID involvement in support of microenterprise finance, and

- Potential project guidelines and program options, utilizing a phased approach.

B. Methodology

Three microenterprise program specialists were contracted by Management Systems International to conduct this microenterprise sector assessment for USAID. The team members selected - Stephen C. Silcox, Karl F. Jensen and Olaf Kula - all have extensive, world-wide program experience in microenterprise finance and program design for USAID. The assessment was conducted over a period of five weeks in January and early February 1996.

The first two weeks in country were spent receiving briefings from USAID, Embassy and Consulate General staff and visiting various financial sector and credit program institutions to gain knowledge of both existing programs and potential options for the development of a microenterprise finance activity in the West Bank and Gaza. The team spent the first week together and then split up during the second, third and fourth weeks in order to cover more territory. A workplan and draft report outline were submitted at the end of the first week. At the end of the second week, the team briefed USAID staff on their preliminary findings.

During the third week, two team members and USAID/WB/G staff traveled to Egypt over a period of four days to visit successful microenterprise finance programs there. One team member remained in the WB/G to continue interviews of relevant organizations and to interview a sampling of various entrepreneurs in WB/G to gain an understanding of their needs and business constraints.

The fourth week involved a two-day visit to Jordan by one team member with considerable past experience there to review the experience of microenterprise finance and loan guarantee programs there. At the same time, the other two team members visited entrepreneurs in other parts of WB/G as well as conducting follow-up interviews with various organizations and financial institutions to refine and confirm the team's understanding of various aspects of the microenterprise finance environment and potential institutional options. Visits were also made to key donors active in either enterprise finance or the economic environment to review their programs and contemplated project activities. At the conclusion of the fourth week, the team presented various options for an USAID-financed microenterprise finance activity. This presentation included recommended target group attributes, methodologies for reaching the target group, institutional options, project financing options and a proposed level of effort and phasing of activities/finance.

During the final week in country, the team prepared a draft report and conducted a final debriefing with USAID and Embassy/Consulate General staff to discuss the team's findings, conclusions and recommendations regarding an USAID-financed microenterprise finance project. This final debriefing included the participation of Elisabeth Rhyne from USAID/Washington, who is responsible for the

Microenterprise Development Office in the Global Bureau. The team met with her prior to their departure from Washington and, consequently, received her valuable input both at the beginning and at the end of this assessment.

C. Format of the Report

This report is comprised of five chapters, including this introductory chapter. The second chapter contains a review of existing financial institutions and various credit programs serving the microenterprise sector in WB/G, as well as other relevant credit programs. It also reviews nonfinancial assistance programs for various levels of enterprises. Particular aspects of the economic and cultural environment relevant to microenterprise finance activities are also covered.

The third chapter provides an analysis of the potential for USAID-financed microenterprise finance activities. This chapter deals with a number of the theoretical and practical issues involved in the justification of USAID involvement in the sector, including the definition of a microenterprise and size of the sector, assessment of demand for finance and elasticity of demand, potential for increased income and employment, and the rationale for USAID involvement in the sector. It should be noted that the empirical data for the analysis of some of these issues was either not available or extremely limited. Since it was not possible, within the time constraints of this assessment, to conduct the necessary surveys to obtain this missing data, the team utilized the limited data available and proxies for this data on which to base its findings.

The fourth chapter conducts a review of best practices in microenterprise finance around the world, with particular reference to USAID experience and policies.

The fifth chapter of this report presents potential program options for an USAID-financed microenterprise finance activity and sets forth the team's recommendations within the context of those options.

Finally, the extensive annexes to the report are composed of two parts. The first five annexes are found in most USAID reports and include the scope of work, workplan, schedule, persons contacted and bibliography. The last nine are more substantive and provide details and case studies on various organizations and microenterprises in the WB/G, trip reports, detailed examples of successful microfinance programs in other parts of the world, a simple model for breakeven analysis of microenterprise finance programs, and guiding principles for donors in selecting intermediaries for microfinance programs.

CHAPTER TWO

REVIEW OF THE ENVIRONMENT FOR MICROENTERPRISE DEVELOPMENT IN THE WEST BANK AND GAZA

A. Banking Institutions

Recent History

Based on the review of the consultancy team, the commercial banking industry is a possible delivery vehicle for credit to the small and microenterprise sector. The following gives a brief overview of the banking industry for Gaza and the West Bank. It should be understood that the banking industry is undergoing dramatic growth, so figures, estimates, and observations are tentative at this time.

The banking industry was suppressed by the Israeli military authorities during the period of the Israeli occupation of the West Bank and Gaza. There were 38 bank branches operating in the WB/G previous to 1967, but nearly all were closed for a period of 20 years, with a scattering of Israeli banks operational during this period. Most of the Israeli banks were forced to close during the Intifada period from 1987 to the Declaration of Principles in 1993. Since that time, there has been a blossoming of bank openings, both from banks that re-established offices as well as new banks opening within the areas of Gaza and the West Bank.

The banking industry, like much of the formal economy of WB/G, is in a state of flux and growth. Most of the banks currently operating in WB/G have intentions of opening other branches to capture more deposits. Most Israeli-owned banks have withdrawn from the WB/G areas. One notable exception is the Israeli-owned, Mercantile Discount Bank which has recently been granted a license by the Palestinian Monetary Authority (PMA) to operate in Bethlehem, but has not yet reopened. Banks operating in the area now are primarily Jordanian-controlled, but three Palestinian-owned banks are currently in operation.

The banks operating in WB/G are under the licensing and supervisory authority of the PMA, although this is somewhat theoretical in that the PMA is not yet staffed. Although the PMA is issuing banking licenses, it is not yet in a position to provide supervision or exert control. The International Monetary Fund is providing assistance to the PMA at this time, and the Arab Bank is lending some staff to the PMA. The foreign owned banks, which are primarily Jordanian, also operate under the supervision of the Central Bank of Jordan. During the period of Israeli occupation, banks had to operate under the supervision of the Bank of Israel (the Central Banking Authority), but this no longer applies. At this point in time, banks must comply with the supervision authority of the PMA and the Central Bank of their mother country.

Size of the Banking Sector

Table 1 - Bank and Branch Network in West Bank and Gaza (January 1996)

Bank Name	Branches 1986-93	New Branches 1994	New Branches 1995	Cumu-lative (Jan. 96)
Cairo-Amman Bank	8	7	1	16
Bank of Palestine	5	3	2	10
Housing Bank	5	3	2	10
Jordan-Kuwait Bank	0	0	1	1
Arab Bank	0	3	4	7
Arab Land Bank	0	3	4	7
Bank of Jordan	0	3	4	7
Jordan-Gulf Bank	0	1	1	2
Commercial Bank of Palestine	0	1	1	2
Palestine Investment Bank	0	0	2	2
Jordan National Bank	0	0	3	3
ANZ Grindlays	0	0	1	1
Total Branches	17	24	24	65

Source: The table above is based on information presented by the "MAS-Palestine Economic Policy Research Institute", advisors to the emerging Palestinian Monetary Authority, and on direct interviews the banks operating within the WB/G.

Currencies

The WB/G economy operates in three currencies, the Jordanian Dinar (JD), the US Dollar (US$), and the New Israeli Shekel (NIS). Banks and businesses deal in all three currencies, although not all banks are in a position to deal with all currencies. As a consequence, intermediation of these currencies is an integral part of the WB/G economies. While various banks offer various intermediation of these currencies, there is a vibrant market for moneychangers. These moneychangers also offer short-term credit. (See discussion under Informal Financial Services below.)

Lending Practices

Banks provide two important services to the community; savings collection and loan provision. While the banks in the WB/G do provide both services, the balance is severely skewed. Total deposits exceed one billion US dollars equivalent (liabilities), and loans (assets) are approximately $220 million.

There has been an apparent "mopping up" of savings from both residents and deposits from Palestinians overseas, but there has yet to be extension of lending within the area now controlled by the Palestinian Authority. Up until this point in time, no firm decisions have been made by the PMA on local reinvestment of deposits; generally funds held by Jordanian-owned banks are reinvested in government securities in Jordan or held to cover transactions with Israeli entities through Israeli correspondent banks.

There is currently a broad range of bank branches providing services in WB/G. However, there are precious few examples of banks lending to small and microenterprises.

Lending practices are conservative, with most loans being for overdraft facilities (86.33%). The remaining breakdown of loans includes term loans of 1-3 years (6.07%), other loans (6.45%) and discounted bills (1.15%) [Percentages from MAS Statistical Review with figures as of March 1995]. The formal banking sector is at least as conservative as the parent banks in the region. On the surface, lending is based on liquid collateral (cash), but underpinned by "name" lending, i. e., lending to members of families that are well known and respected in the area. Wealthier families with businesses recognized within the banking community have far greater access to banking services than poorer, less well known clients. (This is not to be confused with "character-based" lending which is based upon the moral reputation of the potential borrower within her/his local community - see definitions.)

Banks in the WB/G generally only accept instruments such as land registered through the "*TABU*" system, a long-standing recognition of formal land ownership that dates back to the era of Turkish occupation. It is important to note that where formal land ownership has occurred, land ownership is acceptable collateral, but much of the area has not undergone the process of cadastral surveys and subsequent formal identification of land ownership. Moreover, experience elsewhere has shown that land ownership is usually not a good basis for urban microfinance.

Factory machinery is generally not accepted as collateral, based on the lack of formal registry or acceptance of serial number identification. Certificates of title on automobiles, which are often accepted as instruments of collateral, are generally not accepted by the formal banking institutions because of the widespread market of undocumented vehicles which originated from the areas controlled by Israel. As a consequence, lending is primarily based on recognition of local families.

There are some reasons to be hopeful that the banking system can be utilized in the future provision of credit to small and microenterprises. The relatively large number of banks and bank branches necessarily creates a competitive environment. Nearly all of the banking institutions interviewed indicated future plans for doing corporate lending, but there is a very limited market for this type of lending. However, at present, banking services for people with limited financial resources are largely confined to deposit taking. The strongest argument for pursuing bank-led intervention for microfinance is that banks have the infrastructure for handling cash, as well as providing aligned services, such as savings. The major drawback at this point is that most bank officials have little, if any, familiarity with successful microfinance programs; consequently, as experience in other countries has shown, bank representatives will require considerable experience with or exposure to such programs to even consider such type of lending.

The banking system within WB/G is providing some consumer lending. Most of this lending is currently based on lending secured by payroll deductions from the borrower combined with the additional security of co-signers or guarantors. These primarily term loans, are relatively small (generally not more than US$5,000 equivalent), and are extended for a period of one to two years. Under the USAID-managed Loan Portfolio Guarantee Program (LPG), forty to fifty loans in the $5,000-6,000 dollar range have been extended by Jordanian National Bank; all of those loans have a period of one to three years, which would be considered relatively long-term with respect to microenterprise loan products. Cairo-Amman bank has also extended some relatively small loans in the US$10,000-20,000 range. To date, formal financial institutions have not entered into the field of small and microenterprise lending to any discernable degree, but the comparatively small consumer loans that have been issued indicate potential for expanded loan possibilities, including microenterprise lending.

Size of Savings Deposits and Access Issues

The banks, since their reopening, are largely dealing with both remittances of Palestinians working in Israel and other countries, (UNRWA reports that 70% of Gaza's income comes from remittances) as well as handling funds that "returnees" have brought with them from other countries. Banks are not really providing fee-based services, rather, much of their revenue comes from the markup (roughly 3%) between what they pay for deposits and what they are receiving for redeposits in Jordan.

In regard to access to banking services by small savers, most banks cited minimum deposit figures of $100 - $300. However, many potential small depositors are, undoubtedly, unfamiliar with banks and banking practices. As a result, organizations like UNRWA and SCF have gone to some lengths to educate their borrowers in banking practices, including how to operate as savings account. There is little evidence, however, of borrowers wanting to make a deposit and being refused by the banks. On the contrary, most of the banking officials interviewed prided themselves on the number of small depositors they had attracted.

Some, like the Bank of Jordan, were even running monthly lotteries to attract a larger number of savers. These types of lotteries are classic approaches to attracting smaller, not larger, depositors. Palestinian Authority (PA) employees are leaving small amounts from their paychecks within the banking system. Cairo Amman Bank and Arab Bank officials referred to having large numbers of small depositors. This seemed to be reflected by the long queues at teller windows observed during visits by the MSI team to various bank branches. The Bank of Jordan Nablus Branch Manager stated that they had 47,000 depositors at the Nablus Branch alone.

B. Credit Programs

Overview

This section describes and summarizes financial services available for microenterprises in the West Bank and Gaza. There are no commercial banks that directly lend to microenterprises, though several are working with one or more NGOs to extend loans to small businesses. (See details below and in Annex 9.) All of the NGO programs investigated have gone through considerable change in their methodologies in the last two years. Some, like UNRWA and SCF, have reached down to poorer borrowers in their lending portfolios, whereas others like the Economic Development Group and the Arab Development and Credit Company have decided to abandon their microenterprise lending activities and move upmarket to serve small and medium scale enterprises.

Several NGOs have recently launched programs that issue relatively small loans (initial loans in the US$ 200-300 range)for short terms (4-6 months)using internationally accepted microenterprise lending methodologies. These programs have been particularly successful at reaching women.

The portfolio performance of most of the NGOs lending to microenterprises has improved in the last couple of years due to several factors. Much NGO credit granted during the Intifada years was either granted or perceived as relief assistance, not as payable debts. Under Israeli military occupation, loan contracts were not enforceable, making recovery in the case of borrower default very difficult.

All of the NGOs still serving microenterprises have adopted improved and cost efficient technologies for lending, reducing or eliminating the need for collateral, and using solidarity groups or other forms of moral security and character based lending.

All of the microenterprise lending programs visited are too new to accurately assess their performance. UNRWA, SCF and CARE include reaching operational self-sufficiency as one of their targets for the next two to five years. None are close to covering their operating costs given the size of their loan portfolio and the interest rates being charged. Under optimal conditions, SCF and UNRWA could cover all of their operating costs in the next few years, assuming significant portfolio growth.

While several NGOs visited are charging positive real rates of interest, these rates are still at the low end of the range necessary to achieve cost recovery within a reasonable time frame. The best of the NGO programs in the WB/G are still basing their interest rates on what they think their borrowers can be reasonably expected to pay and not on what it will cost to deliver those loans as the program reaches scale.

NGO linkages to commercial sources of funds, an important means of achieving institutional sustainability, is either lacking or nascent. A number of NGOs encourage or require that their clients maintain savings in a commercial bank, and bank support for microenterprise lending is primarily limited to channeling funds in and out of the NGOs' accounts. Banks generally receive a nominal fee (1% - 1.5%) for this service. None of the NGOs interviewed plan to access commercial sources of funds as a means of scaling up and becoming sustainable in the near future. Save the Children Foundation recognizes the eventual need to access commercial sources of funds and has calculated the opportunity cost of funds in some of their financial projections.

NGOs and Microenterprise Finance

The following NGOs are now providing some level of micro and small enterprise finance in the West Bank and/ or Gaza. Various aspects about the programs are compared in Table 2. (For a more detailed description of these programs, see Annex 9.)

United Nations Refugee and Works Agency (UNRWA) is currently operating three micro-and small scale enterprise lending programs: The Small Scale Enterprise Fund, the Microenterprise Credit Project which targets men but is open to women, and the Women's Solidarity Groups Lending Program which only lends to women. Only two of the three programs, the Solidarity Group Lending Program, and the Microenterprise Lending Program, target microenterprises.

For both of the microenterprise lending programs borrowers pay 2.2% per month interest on short term loans from six months to one year (with an effective interest rate of 41.5%). UNRWA is looking for additional donor funds as a means to expand the outreach of their programs.

Save the Children Foundation (SCF) is a notable exception among the various NGOs providing financial services, decreasing its loan size to ensure access by the most underserved population in WB/G -- poor refugee women. SCF uses a solidarity group methodology to make individual loans.

Since June 1995, 525 loans have been made to 497 borrowers. Loan disbursals total US$ 233,000, with an average loan size of US$444. Loans are repaid at 22% annual interest in bi-monthly payments with six month terms (with an effective interest rate of 44.16%).

CARE International has begun a pilot microenterprise finance project, financed from its own funds that appears well designed, recognizes the importance of achieving sustainability, and is looking to capitalize it loan funds with donor financing and an increasing share of participant savings.

The CARE model, based on a village banking methodology, provides matching capital to each group based on a minimum member savings. Initial loans are for three hundred dollars, second loans for $500. The pilot activity is still in its first round of loans.

American Near East Refugee Aid (ANERA) has worked with a diverse set of mechanisms to deliver small loans to microenterprises. Only two of ANERA's programs target microenterprises, the first through agricultural cooperatives, the second targeting women, uses local NGOs to manage the portfolio and funds. Both of these programs began in 1995.

Indicators	Outreach				Sustainability			Performance		Methodology	Observations
Program or Institution	# of Borrowers	% Women	# of Loans	Loan Size	Effective Interest Rate	Plans to Access Commercial Sources of	Institutional factors	Cost per dollar lent	Repayment Rate		
A. UNRWA											
Solidarity Group Lending	approx.630	100	756	NIS 2,000-4,000	41.47%	no	UNRWA managed, no indigenous org. to assume control	n/a	>98%	solidarity group	
Microenterprise Credit Project	N/A	very low	N/A	Up to USD 10,000	41.47%	no		N/A	N/A	individual loans	new program, no loans are due yet
B. Save the Children Foundation (SCF)											
Group Guarantee Lending Scheme	497	100	525	USD 444	44.15%	no	NGO managed, plans to spin off model to local NGOs	$0.66	99.7%	solidarity group	
C. ANERA											
Women's Loan Fund, Gaza	<50	100	<50	max. USD 5,000	15.3%	no	managed by indigenous NGOs with little or no finance experience	high	80%	individual loans	
Small Agricultural Loan Fund	N/A	<10%	610	max. USD 5,000	15.19%	no	loan funds managed by cooperatives	high	88%	individual loans	
D. CARE Microcredit Program	20	100%	20	$300	40.15%	program will eventually be financed out of participant savings	Proposes to create autonomous village banks	expects to reach break-even year four	to early to calculate	Village Bank	Pilot Project seeking donor funds, too early to evaluate
E. Economic Development Group (EDG)	n/a	<10%	approx. 2,000	80% < USD 10,000	15%-17%	yes	Indigenous management, strong board	high	90%	individual loans	EDG is diminishing its micro- portfolio
F. Arab Development Credit Corp. (ADCC)	N/A	<10%	975	av. USD 7,300	15%-17%	yes	Indigenous management, strong board	high	70%	individual loans	ADCC is diminishing its micro- portfolio
G. Cooperation for Development (CD)	78	<10%	78	USD 5,000-10,000	13.3%	program guarantees bank loans	weak managment structure	extremely high	<80%	individual loans	

Table 2 - Comparison of Various NGO Credit Programs

With considerable experience in a variety of credit programs, ANERA has not made the hard decisions necessary for these activities to become operationally self-sufficient, in the medium term and sustainable in the long run. While all the ANERA programs are charging positive real rates of interest, none of them charges enough to become operationally self-sufficient.

Bank Linkages with NGOs

SCF, UNRWA, ANERA, and CARE all have established linkages with local banks. The nature of the relationship typically has the bank operate as a transactions window for the NGO, where the borrower withdraws funds from and pays back into the NGO's account. The bank generally receives a fee for this service. With the ANERA managed guarantee fund, the Arab Bank assumes 25% of the risk and assumes all loan origination and management costs. All of the NGO programs also either require or encourage their borrowers to establish and maintain savings accounts in one or more of the commercial banks.

In spite of the limited role of banks in financing microenterprises, there are already some benefits from the existing linkages. The initial bank exposure to microenterprise borrowers by well managed programs is an important first step in building a more direct and involved bank-microenterprise relationship. Second, the banks are already providing a valuable cash handling service, along with exposing microentrepreneurs to bank practices such as deposit taking, and the habit of making regular loan payments.

Informal Financial Services

Informal sources of finance are still the most important suppliers of short term credit. The majority of microenterprise financing in the WB/G comes from personal savings, remittances and family. Financing from informal credit makes up the next largest source of financing for microenterprises. Informal sources include supplier credit, formal and informal money changers, and informal rotating savings and credit associations (ROSCAs) called *jamiiyaa.* The informal sector is the *de facto* provider of financial services to the microenterprise sector. In the absence of an established formal or semi-formal market for microenterprise credit capable of meeting demand, informal interest rates represent the market rate of interest for microenterprise credit. The effective interest rate for informal, short-term microenterprise loans ranges from 60% to 300% annual. These figures supplied by UNRWA staff were confirmed by interviews with both moneychangers and microentrepreneurs.

Supplier credit plays an important role in financing inventory of many firms involved in small commerce. Microenterprises involved in trade purchase inventory on short term credit, repaying after the merchandise is sold (usually within one week to one month). Because the credit transaction is linked to the sale of goods, the charges for the use of funds varies with the supply and demand for the linked commodity. Because microenterprises operate in a highly competitive environment, they are much more likely to offer their goods on credit to customers with little or no mark-up, even though they might have to pay a considerable mark-up on goods they purchase. Some microentrepreneurs interviewed stated that they pay up to twenty-five percent surcharges for goods that they repay within a week to a month. Thus, supplier credit is often extremely costly.

Moneychangers operate throughout the WB/G. The strict collateral requirements, equity-based lending policies and long loan evaluation processes of commercial banks, cause even relatively sophisticated small and microenterprises to use moneychangers as a source of short-term working capital. Interest rates vary from a low of 5% per month, to a high of 8% per week [UNRWA and personal interviews, 1996]. Most of the loans made by the moneychangers are for personal, family and emergency obligations while a smaller number are for short term working capital needs of microenterprises.

Moneychangers lend only to a relatively small group of trusted people known to the moneychanger. This character-based lending is characteristic of informal credit providers. In addition, moneychangers in the WB/G also take postdated checks as repayment security. Borrowers who do not honor their postdated checks face criminal charges, a strong incentive to repay in those rare instances that the moneychanger misjudged the borrowers commitment to repay.

Jamiiy'aa is an Arabic term used for the informal rotating savings and credit associations (ROSCAs). These groups are quite common in the WB/G, especially among women. Members meet on a regular basis to make their contribution and disperse the funds to one member. Each member withdraws the pool of funds collected by the *Jamiiy'aa* on a rotating basis.

Other Relevant Credit Programs

Most of the NGOs lending in the WB/G do not target microenterprises. Some programs like the EDG and the ADCC have made microenterprise loans in the past but are now abandoning that sector. Difficult economic conditions, a political environment that made enforcement of loan contracts impossible, and poorly structured loan programs resulted in very poor performance of the microenterprise lending activities during the Intifada years.

The **Palestinian Development Fund** is the new umbrella under which three Palestinian NGOs that provide financial services to the small and medium enterprise sector in the WB/G are being reorganized. The three NGOs that will make up the new PDF are summarized below.

The **Arab Development and Credit Corporation (ADCC)** focuses largely on financing agricultural projects with a smaller portfolio of industrial and service sector loans. Most loans are for 1 to 3 years, with some for 5 years. Borrowers pay 7.5 % interest on loans less than three years and 8.5% on loans three years or longer. As of January 1996, The ADCC had 975 loans on their books representing US$ 7.12 million, for an average loan size of US$ 7,300. Repayment rates have been very low, but are improving. The current repayment rate approaches 70%.

The **Economic Development Group (EDG)** made a decision in 1992 to shift its focus from microenterprise lending to small and medium enterprise lending and to the financing of tourism and light industrial activities. Many of its loans are still to businesses that could be considered the larger or more dynamic firms in the microenterprise sector. Most loans are for existing businesses, though the EDG will occasionally finance new business start-ups. Since its inception, over US$ 10 million have been disbursed (60% of which has been disbursed since 1993). The maximum loan size is US$ 400,000 or 50% of the value of invested capital in the enterprise excluding land and buildings. Eighty percent of all loans are under US$ 10,000.

The **Technical Development Corporation (TDC)** focuses on medium and large scale industrial and tourism activities and is the newest and most commercial of the three NGOs about to merge. The first loans were made in 1990. Loans are from US$ 50,000-100,000. Repayment rates are 92% for loans over 90 days past due. The interest rate of 7% charged on loans defrays but does not cover TDC operating costs.

Cooperation for Development (CD) is a UK-funded microenterprise program that has been operating in the West Bank and Gaza since 1983 targeting small and medium enterprises. CD provides loans for 1 to 3 years for 7% per year simple interest. Loans are granted through three commercial banks - Cairo Amman Bank, Bank of Palestine and Jordan Bank. The CD finances up to 50% of the project excluding land and buildings.

Home Improvement Lending Program

Under a project managed by the Cooperative Housing Foundation (CHF), USAID has financed a home improvement loan fund. As of January 1996, approximately US$1 million had been extended for housing improvement loans with an additional $3 million to be extended by September 30th. These loans are mainly in the US$6,000-7,000 range and are channeled through the Arab Bank and Cairo Amman Bank. The first loans were made in October 1995. All risk loan management and recovery costs are born by CHF (85-90%) and the banks (10 - 15%).

C. Non-Financial Support Programs

Non-financial assistance programs for microenterprises in the WB/G are extremely limited. The few operational business associations and Chambers of Commerce are weak and struggling to find ways of serving their members. Microenterprises are not part of the target group of these organizations.

Private sector firms in the WB/G face numerous constraints arising from the unresolved political and economic questions between Israel and the Palestinian Authorities. Restrictions on the movement of goods and labor between the West Bank and Gaza, and Israel is paramount. Access to international markets, both for capital and equipment to be used in the production processes by Palestinian firms and for the products of those firms is restricted. Market and infrastructure constraints were cited as significant even by microenterprises. Enterprises of all sizes will benefit from future improvements in the infrastructure and political environment between the WB/G and Israel.

There are no organizations currently addressing the non-financial constraints faced by microenterprises in a systematic manner, although several NGOs provide business management training on a limited scale.

For the delivery of non-financial services to be sustainable, rigorous standards similar to those practiced by well run microenterprise finance programs must be applied. Programs should respond to identified demand, and technologies for delivering assistance must be cost effective and reach large numbers of microenterprises at a relatively low cost. Achieving the above can benefit from interventions that are subsector specific, targeting high growth potential subsectors. In selected cases, the microenterprise beneficiaries are able to support some, if not all, of the costs of delivering assistance.

D. Economic and Cultural Factors

Key Economic Factors Affecting Microenterprises

Limitations on the free movement of people and goods

The frequent border closures and the slowness of border crossings for both people and goods between WB/G and Israel present substantial efficiency losses which translate into higher product costs for items produced in WB/G. The elimination of restrictions on the freedom of movement of people and goods between state borders is viewed as one of the first actions of the United States government in its early years which was critical to the development of a national economy. Likewise, the establishment of free trade zones among neighboring countries in Europe (e. g., Benelux) and the attempt to reduce barriers to trade throughout Europe by the European Union recognize the importance of border barriers in limiting trade.

This factor has a major impact on the potential for goods produced in the WB/G to be sold in Israel or for Gazan goods to be sold in the West Bank and vice versa. It likewise increases the costs of export of WB/G goods to other countries, both in the region and to more distant markets.

Although these factors affect the economy in the WB/G as a whole and, thereby, the purchasing power of WB/G residents, their impact on microenterprises is much more limited than on small and medium scale enterprises. This is because most of the products produced or items sold in the WB/G by microenterprises are for the local market; microenterprises are not generally in the export business. Furthermore, the scale of operations and flexibility of the microenterprises to find alternative sources of inputs and operate in the informal market limits the impact of these border restrictions.

This is not to minimize the need to reduce and eliminate these restrictions on the free movement of people and goods over the long-term; the removal of these barriers is critical to the improvement of the WB/G economy as a whole. However, their limited impact on microenterprises allows USAID to consider the implementation of microenterprise finance activities prior to the elimination of these barriers and to understand that microenterprises in WB/G can increase their production and turnover even under these difficult conditions.

<u>Cutbacks in the use of WB/G Palestinian workers in the Israeli economy</u>

A second significant economic factor affecting microenterprises in the WB/G is the cutbacks in the use of Palestinians from the West Bank and, especially, Gaza in the Israeli economy. According to the American Embassy Commercial Guide for the West Bank and Gaza published in July 1995, prior to the Intifada in 1987 approximately 125,000 Palestinians worked in Israel; in contrast, in July 1995 only 33,000 Palestinians were working in Israel. A representative of the Israeli Ministry of Labor stated in a telephone interview that there are currently 58,750 workpermits issued to Palestinians to work in Israel. Of those, 35,450 were issued for the West Bank and 23,300 for Gaza.

A brief historical review of the linkage of the WB/G and Israel economies might help to put these figures in perspective.

> Prior to its occupation by Israel in 1967, the West Bank was an integral part of Jordan both politically and economically. Gaza, on the other hand was administered by Egypt and had economic links with Egypt and Eastern Europe, then Egypt's main trading partner. Economic ties between the West Bank and Gaza, geographically separated by Israel, were nonexistent.
>
> The situation changed dramatically with the occupation, after which both the West Bank and Gaza were enveloped in a one-sided customs union with Israel. This customs union entailed exports from Israel to the two regions and labor flows in the opposite direction. But while the economies of the West Bank and Gaza became extensively linked to Israel, they remained isolated from each other.... (Journal of Palestinian Studies XXIV, no. 2 (Winter 1995), pp. 16)

The drastic reduction in work permits has had a substantial impact on the incomes of those Palestinians from the WB/G formerly working in Israel. While there are hopes and indications that work permits for Palestinians may increase to previous levels, there is some concern that reported increases in immigrants from Eastern Europe and Asia have replaced an undefined portion of the jobs which formerly were filled by Palestinians from WB/G. Whether the number of Palestinians in WB/G will ever reach pre-Intifada levels is in doubt by some sources.

Despite these difficulties, a recent report from the Economic Officer for the US Embassy in Tel Aviv responsible for Gaza was hopeful. That report states,

> Contrary to expectations, there is good news in Gaza's industrial sector. While industry contributes only a model 9-10 percent to Gaza's GDP, 1995 Palestinian statistics show a growth in the number of firms, a jump in overall revenues by over 200 percent, and an increase of 45 percent in the number of workers employed. (Cable from American Embassy/Tel Aviv, 21 Nov. 1995)

Gazan sources contend that much of the recent growth in the Gazan economy was due to a dramatic increase in building construction fueled by remittances from Gazans living abroad who now view investments in property in Gaza as a viable alternative, since the advent of the Peace Process. Whether this pace of new construction will continue over the long term is doubtful and the ability of new businesses in Gaza to replace jobs in Israel to a substantive extent is still in question; however, real estate prices in Gaza City have skyrocketed.

The reduction in work permits has obviously had an impact in limiting the disposable income from those former workers and their families. This has had a corresponding effect on microenterprises in WB/G in a number of ways:

- Many new microenterprises have been established in WB/G, either by the former workers themselves or by their spouses, to replace at least a part of the income that formerly came from wage labor in Israel. If work in Israel returns, some of these microentrepreneurs would probably go back to their former jobs and abandon their microenterprises.

- The loss of income from jobs in Israel has diminished the ability of those affected to purchase many household items.

- Most of the microenterprises interviewed by the MSI team sold basic household necessities, such as clothes and food items, which are less affected by the loss in disposable income than other, non-perishable, items which can be deferred until income increases to former levels.

In conclusion, the restrictions on the movement of people and products across WB/G and Israel borders has had an overall negative impact on the WB/G economy, but its negative impact on microenterprise development is considerably less, on balance, than upon small and medium enterprises. Experience in developing countries has demonstrated that the informal sector, including microenterprises, has tended to flourish when there are downturns in the formal economy. This can result in an increased demand for microenterprise credit in the short-term, but can pose certain risks to the long-term sustainability of a microfinance institution. If improvements in the economy diminish the demand for microfinance below the level necessary for a microfinance institution to achieve sufficient scale to cover operational costs, the sustainability of the institution could be at risk.

Any contemplated microfinance program by USAID must take these considerations into account. However the linkage of the WB/G with Israel will likely continue for the foreseeable future, even with potential increased trade with other neighboring countries and countries further afield. On balance, it appears that the constraints to the WB/G economy caused by border closures and reductions in Israeli workpermits for Palestinians should not impede the development of microenterprise finance project in WB/G and should have limited effect on the demand for near to medium-term microenterprise credit.

Key Cultural Factors Affecting Microenterprise Finance Programs

Women's roles

The role of women in Palestinian society is strongly affected by the historical role of women in Arab societies. While considerably less conservative than the Gulf, male perceptions of the role of Palestinian women have been similar. These have been modified to some extent through contacts with Europeans and other Westerners, but most Palestinians continue to place importance upon the woman's role as a homemaker and the raising of children. This perception has limited the role of women in income-generating activities outside the home to some extent, particularly among lower income Palestinians.

A study commissioned by USAID in late 1994 on gender issues in the WB/G provided much information on women's roles in various sectors, including housing, health, the private sector and democracy/governance. That study presented the following picture of women in business and in the labor force.

> According to the World Bank, the rate of women's participation in the formal labor force in the West Bank is estimated at 8.8% of the population 15 years and older; and in the Gaza Strip, the comparable figure is 1.7%. Many indicators suggest that an increasing number of women are entering the labor force in both the formal and informal sectors. In a study by Hindiyeh and Ghazawneh, they estimate that women in the West Bank and Gaza Strip, including part-time workers, make up one fourth of the labor force.
>
> Women's increased need to work results from several factors, including: declines in remittance income, traditionally a source of investment capital and subsidies; and high unemployment among men due to Israeli imposed restrictions on the number of Palestinians working in Israel. Available data indicate that more and more women are working in the informal economy where some establish small businesses in their homes (sewing, knitting, embroidery) while others labor long hours at irregular wages vending a variety of products on urban streets. Women also play a significant role in agriculture and livestock. In all these endeavors women experience myriad problems. Among the most serious is women's lack of marketing and management skills and their inability to access credit and other informational resources, problems within the purview of USAID's strategy to address. (Roy, Dr. Sara, et. al., "West Bank Gender Assessment," MSI/USAID, December 1994,)

Two existing microenterprise finance programs run by UNRWA and SCF specifically target women microentrepreneurs as part of their group-based lending schemes. The experiences of both programs have demonstrated that microenterprise credit to women-run enterprises can assist those women to expand their businesses and increase their incomes and have high repayment rates. This is consistent with many microenterprise credit programs in other parts of the world.

Certain constraints for women-owned microenterprises, such as access to credit, pose external constraints on the expansion and growth of the business; whereas, others may be self-imposed. For example, the study mentioned above stated that, "Married women interviewed for this report indicated that they preferred jobs that started early in the morning and ended early in the afternoon, when their children were finished with school, so that they could be at home with their children." Successful USAID-financed microenterprise credit programs in Egypt have tended to have low participation by women. While a new microenterprise finance project for WB/G financed by USAID would be open to both men and women, consideration would have to be given to the design of methodologies which address the specific needs of women in order to overcome the abovementioned constraints and experience elsewhere. The SCF and UNRWA programs can provide important lessons in this regard.

Interest on loans

The Islamic prohibition against interest charged on loans is often a concern in Islamic countries. Although most moderate to high income residents in the Middle East are accustomed to paying interest to banks and other financial institutions, this issue often is raised in regard to low income or rural persons, who tend to have a more traditional attitude. This issue has particular relevance to a microenterprise finance project, since the target group for these projects tend to be low income individuals and the interest rate charged is almost always higher than commercial bank lending rates.

Both the UNRWA and the SCF programs faced problems on this issue early on during program implementation. They both claim that they were able to resolve the problems by using a nonconfrontational approach which sought to deal directly with the concerned individuals and to demonstrate the basis for interest rate charged. Staff explained to the complainants that the interest was necessary in order to maintain the program and that if individuals felt strongly against paying interest, they did not have to join the program. It would appear that this approach has succeeded.

Based on the experience of UNRWA and SCF, and recognizing that the majority of the microenterprises which would be receiving finance will be urban-based, it is unlikely that the Islamic prohibition against interest on moneylending would present substantial implementation problems for a USAID-financed microenterprise finance project. Any potential problems on this issue appear surmountable if an approach similar to UNRWA and SCF is used.

CHAPTER THREE

ANALYSIS OF POTENTIAL FOR USAID-FINANCED MICROENTERPRISE FINANCE SUPPORT ACTIVITIES

A. Estimated Size of the Microenterprise Sector in the WB/Gaza and a Working Definition of Microenterprises for a Proposed Microfinance Project

Estimated Size of the Sector

To date, household and microenterprise business level surveys have not been carried out in the WB/G, at least over the past nine years. Previous to the start of the Intifada in 1987, the Israeli Central Bureau of Statistics included the occupied areas of the West Bank and Gaza in its reviews. Since that time, the sources of information on employment by sector have become more limited. The following is an extrapolation of data presented in the Palestinian Central Bureau of Statistics (PCBS) study commissioned by the International Labor Organization. The data utilized comes from both the text and tables presented in "Labor Force Statistics In the West Bank and Gaza Strip", May 1995.

Due to the paucity of hard data on microenterprises in the WB/G, the MSI team had to rely on impressions of persons interviewed and labor force statistics from the PCBS regarding employment to roughly estimate the size of the microenterprise sector.

Estimates indicate that there are currently about two million residents in WB/G. Of that population, one half (those over 16 years of age) are assumed to be employable. About 35% of the total employable population is unemployed, but 25-30% of the employed population is reported as self-employed. Using this category of persons as a proxy for possible microentrepreneurs, the total microentrepreneurs in the WB/G would be conservatively estimated to number at least 150,000.

Based on information available from other sources, approximately 90% of existing private businesses in the WB/G have less than ten employees and at least 80% of existing businesses have less than 5 employees.

Working Definition of a Microenterprise

For the purposes of a potential USAID-financed microenterprise finance project, a "microenterprise" could be defined as a business with ten or less employees. This is consistent with the USAID worldwide definition of microenterprises and applies broadly to the situation in WB/G. One could further refine the operational definition for a proposed microfinance project, however, by providing special emphasis on existing businesses with less than five employees and with capital requirements of less than $10,000. As a consequence, priority would be placed on providing funds to intermediary agencies focussing on smaller businesses. This targeting of microenterprises currently without access to credit from the banking sector would fit well within the USAID/Washington Global Bureau's strategy of reaching microenterprise markets unserved by other institutions and donors.

B. Assessment of Demand for Microenterprise Finance and Demand Elasticity Factors

In the absence of solid microenterprise survey data, it is difficult to estimate the demand for credit or the price elasticity of demand for credit by microenterprises in the WB/G. In the context of this sector assessment, the establishment of several parameters serve as substitutes for an accurate demand assessment. The critical questions preceding the design of a microenterprise finance project are:

- Is there sufficient demand to enable a microenterprise credit institution to achieve sufficient scale in its lending program to become sustainable?
- Will there continue to be sufficient demand for microenterprise loans at the interest rates needed to recover all of the costs of lending?
- Does the lower bound of estimated microenterprise demand for credit justify the amount proposed for loan capitalization in this assessment?

Demand for Microenterprise Credit

There is no data available at this time to calculate the upper bound for loan demand in the WB/G. Such information could be obtained using a baseline survey methodology as used under the GEMINI project, or conducting a microenterprise survey using a variety of sampling techniques. In addition, if household enterprises were included in census data as well as other self-employment activities, a reasonable assessment of demand could be constructed. This information does not currently exist in the WB/G. Nevertheless, there is substantial evidence that the demand for microenterprise loans already greatly exceeds the level needed to reach sufficient scale for an microenterprise lending program to be sustainable. Consequently, the MSI team does not believe that a full blown survey such as that described above is necessary to justify a microfinance project by USAID.

Both SCF and UNRWA have done initial assessments of potential demand for their women's solidarity group lending schemes for both the West Bank and Gaza. In Gaza alone, there are an estimated three thousand women operating retail activities with a fixed place of business in existing markets. According to UNRWA staff, the number of women in the WB/G who operate home-based businesses is higher than the number of those with market stalls. UNRWA staff estimate the demand among women microentrepreneurs at a minimum of 5,000 borrowers.

Another conservative estimate of demand is to assume that at least 10% of the microenterprises in the WB/G would both be interested in and qualify for a microenterprise loan. This approach safely yields 15,000 borrowers. Given that there are fewer than one thousand microenterprise loans made in all of the WB/G today, it is reasonable to assume that there is a considerable "credit gap" at interest rates sufficient to cover the costs of microenterprise lending.

Interest Rates and the Demand for Finance (Price Elasticity of Demand)

The price elasticity for the size and terms of loans demanded by microenterprises is low or inelastic, meaning that the microenterprise demand for loans is not sensitive to changes in interest rates within the range of rates charged by successful microenterprise credit programs. Borrower sensitivity to loan fees is a function of the following:

Inventory turnover of the product being sold by the microenterprise. Most microenterprises have very high inventory turnovers, in part because they cannot afford to maintain high levels of inventory. For this reason, they can usually support relatively high levels of interest for working capital. Most of the enterprises contacted during this study turn over their inventory in one to four weeks. High inventory turnover enables enterprises to support relatively higher costs of working capital.

Price of substitute sources of capital. Since the existing microenterprise programs which are charging between 11% - 22% per year serve so few borrowers, the major source of credit for most microenterprises are informal lenders and supplier credit. These sources of credit cost between 60%-300% at effective interest rates. Given that reasonably well managed microenterprise credit programs can deliver microenterprise loans on a cost recoverable basis for 35% or higher real interest, borrowers should be relatively insensitive to moderate increases in interest charges at ranges substantially lower than those provided by the informal sector.

Demand elasticities of products sold. The vast majority of microenterprises in the WB/G appear to be involved in the production or trade of goods whose demand is relatively insensitive to price changes. Food, household goods, and clothes are generally considered necessity items, and as such are relatively insensitive to price changes. Fewer microenterprises in the WB/G are involved in the production or trade of luxury goods which are more sensitive to price changes.

Demand elasticities for credit are particularly important if the overriding programmatic objective is to increase loan numbers (rather than the sustainability of the lending institution). If demand were elastic, that is if borrowers would want fewer loans of smaller amounts as interest rates rose, one could argue for loan subsidies in order to maintain or stimulate demand. Under this supply led belief, marginal increases in interest rates will create a significant constraint on the quantity of funds demanded. Proponents of this belief argue that demand for loan funds is very elastic, and therefore small changes in the cost of funds will have a large impact on the amount of funds demanded. Thus to stimulate demand, the appropriate response is to hold down the cost of funds. In fact this is not the case with well run microenterprise programs.

If sustainable access to credit is the objective, demand elasticity is secondary in importance to the determination of what it will cost to deliver microenterprise loans. In this scenario, the market rate of interest becomes largely irrelevant. In fact, in most developing societies, there is no market rate of interest for microenterprise credit, because there is no formal market for microenterprise credit. Regardless of what other markets charge, no microenterprise credit facility can ever become sustainable unless it can cover all of its costs, including bad debt loss and profit, through its fees or interest rates.

On the other hand, once an interest rate based on real costs to the credit facility of delivering credit has been set, it then becomes important to determine whether sufficient demand exists at that level. Because most microenterprises have no alternative sources of credit at rates below the cost of informal credit, demand elasticities are not a realistic concern for a proposed USAID-financed microenterprise finance project.

Capitalization needs. Assuming a minimum of 15,000 borrowers in the West Bank and Gaza, with an average loan size of US$600, total loan demand would equal US$9 million dollars. This is a lower bound estimate for microenterprise credit assuming that only ten percent of the microenterprises with a fixed place of business would be eligible for and interested in a microenterprise working capital loan. Assuming either a larger average loan size, or a higher eligibility rate than 10% would increase the demand estimate. This amount, assuming an average loan size not larger than US$ 600, would generate several times the number of loans needed to operate a sustainable microenterprise program.

C. Potential for Increased Income and Employment Resulting from Microfinance Assistance

Financial services for microenterprises are much more likely to increase the incomes of microentrepreneurs and reduce underemployment. In an environment where a microenterprise is often the only alternative to unemployment, income enhancement is the more important objective. Extensive, multi-country, GEMINI studies of the growth and dynamics of microenterprises indicate that only a small percentage of microenterprises expand to employ over 10 people.

Income Generation

The major contribution of microenterprise financial assistance programs is in increasing incomes, not employment. Investment in microenterprises often reduces underemployment of microenterprise owners and, in so doing, increases the incomes of microenterprise owners, employees and their families. Increased incomes enable poor families to accumulate savings against emergencies and to increase consumption and capital investment. In the WB/G, microenterprises provide the only source of income for thousands of families. Many of these are operated by women because their husbands and male children are either temporarily unemployed or disabled.

Many of the women microenterprise operators interviewed stated that they started their businesses because their husbands were unable to find work. These women had become the *de facto* heads of households and were supporting their families on income from their enterprises. Investment in microenterprises enables large numbers of poor households to improve the standard of living for their families.

The income effect from microenterprise lending can be calculated as the returns to capital invested in microenterprise activities minus the financial cost of borrowing those funds from a microenterprise finance facility. The estimated returns from capital invested in microenterprises is equal to the financial cost of capital in the absence of a microenterprise lending facility (the informal credit rate). The rationale for this approach is that an enterprise will continue to borrow funds until the marginal returns from invested funds falls to zero. Microentrepreneurs borrow from informal sources at effective interest rates of 60%-300% because even at those rates, they are earning some positive return on invested capital. This means that the marginal returns to invested capital for microenterprises ranges from 60% to 300%.

This is consistent with both logic and empirical evidence. Microenterprises tend to be very labor intensive, and will continue to invest in labor (at least their own) until the returns to labor fall to zero. This is because much microenterprise activity is an alternative to unemployment, which provides a zero return. The returns to units of capital invested in microenterprises can be very high. Microentrepreneurs make a rationing decision to maximize units of invested labor per unit of capital. This is consistent with findings from West Africa where income statements of microenterprise activities indicated returns to capital of 3%-15% per week, or 150%- 720% annual. Similar returns to capital were identified in conversations with village agents in a Bangladeshi NGO.

Restated, the income effect of a microenterprise loan is the marginal returns to invested capital, minus the opportunity cost of providing that capital. Since well managed microenterprise programs worldwide appear to cover all the costs of lending at interest rates at 35% or higher, the lower, more conservative, bound of the income effect of microenterprise loans is estimated at 150% (lower estimate of marginal returns to microenterprise activity) -40% (upper bound of what it costs to make microenterprise loans) = 90%.

Assuming marginal net returns to microenterprises, the income effect of microenterprise loans justifies its investment regardless of the employment effect.

Employment Generation

Methodologies for calculating the employment impact of microenterprise loans tend to be based on the level of invested capital excluding land and buildings. UNRWA estimates that a new job is created for every three thousand dollars invested in a microenterprise(1996). Save the Children Foundation estimates that it takes substantially less to employ a women.

There is a problem with this analysis. There is no evidence that most microenterprises will hire additional workers as their incomes expand. When incomes do expand, other family members are often employed. While there is considerable evidence that working capital loans assist microenterprise operators increase their income, the employment effect of microenterprise credit is less clear. For those microenterprises that expand, many will invest in machinery or equipment rather than additional workers. Most microenterprises are very labor intensive. This means that the relative returns to capital are much higher than for labor because the microenterprise operator continues to add units of labor until the relative returns approach zero.

Most microenterprises do not grow. The great majority start out and end up as one-person enterprises. About 25% grow but remain microenterprises. Less than 1% grow to become small and medium sized firms. [GEMINI working paper No. 36 (1993)]

The absolute magnitude of the microenterprise sector in the WB/G indicates that there will be a significant employment impact even if only a very small percentage of microenterprises grow. Most successful small and medium scale enterprises begin as microenterprises. If only one percent of the 150,000 microenterprises in the WB/G expanded enough to add 10 employees each, the employment impact would be 15,000 new jobs.

D. Rationale for USAID Involvement in Support of Microenterprise Finance

A number of factors justify USAID support of a microenterprise finance project. Some are country-specific and others apply world-wide. The various factors are detailed below.

A microenterprise finance project has the potential for immediate impact on low-income Palestinians through increases in income and business expansion.

The concern for addressing the needs of Palestinians in the WB/G and demonstrating positive results from the Peace Process as soon as possible to reinforce public support for the Peace Process is an important objective of donor aid. As an article in an World Bank publication in September 1994 stated,

> ...there is a need to strike a balance between the imperatives of showing tangible results in the short term and laying the foundation for sustainable growth in the longer term......Therefore, poverty alleviation and employment creation programs are essential during the initial period. (Prem C. Garg & Samir El-Khouri, "Aiding the Development Effort for the West Bank and Gaza," Finance and Development, September 1994, p. 7.)

A well-structured microenterprise finance project would serve both the immediate political ends to address the needs of low income Palestinians as well as long term development institutional needs.

Effective intermediaries providing microenterprise credit can have relative immediate impact on low income Palestinians since well-run microenterprise programs could provide substantial numbers of loans to assist microentrepreneurs throughout the WB/G in a relative short period of time. The methodology used by microenterprise finance programs emphasizes the quick turnaround of capital and repeat loans for microentrepreneurs who repay their loans on time. Furthermore, experience elsewhere shows that many microfinance programs directly benefit women and their families in terms of increased family income. This is very important both in demonstrating program impact and in providing opportunities for donors to publicize their efforts to assist in the development of the economy and to accomplish social welfare objectives.

A microenterprise finance project would help to create local, sustainable institutions to provide long-term development through a local source of finance for microenterprises.

The economic development of WB/G depends upon the establishment of local institutions which serve the needs of Palestinians over the long-term and are sustainable without donor aid. USAID's experience with microenterprise finance institutions elsewhere demonstrate that this objective can be achieved by a well-designed microenterprise finance project. Examples of successful programs in other parts of the world are cited in the next chapter of this report. While institutional development is frequently difficult to attain within the short-term context of most development aid, USAID has experience with a number of models to accomplish this goal, while providing direct assistance to microentrepreneurs at the same time.

A microenterprise finance program would help to develop the private sector from the bottom up.

The development of the private sector is an important aspect of development aid to WB/G. While assistance to create the proper economic and policy environment is critical as well as the encouragement of foreign investment in WB/G, support for private sector development at the grass roots level can set the stage for long term economic growth. A microenterprise finance project would help promote both participation and commitment to a private sector economy among average Palestinians. This is a concrete step which can counter criticism that development aid only helps those with political or economic influence.

USAID has a comparative advantage over other donors in microenterprise finance and extensive worldwide experience which would be brought to bear on any project in WB/G.

USAID is recognized within the donor community as the leader in microenterprise finance with world-wide experience in the field. The Global Bureau has an Office of Microenterprise Development to provide technical support and supplemental financing of selected microenterprise activities. USAID has been active in microenterprise development with a specific office to support the activity since the early 1980s. The PISCES, ARIES and GEMINI Projects, funded through that central office in Washington, have monitored various microenterprise projects worldwide and have drawn and disseminated lessons learned from those projects to promote best practices in microenterprise development.

Agency-wide policy directives in the area of microenterprise finance, which has had the most significant success of all microenterprise development projects, have been developed to guide Missions in the design and implementation of microenterprise finance projects. The design and implementation of a microenterprise finance project in WB/G would benefit from this support and guidance. The next chapter of this report attempts to provide the reader of this report with some principles and examples of well-designed microenterprise finance projects.

Most other donors in the WB/G are not active in the area of microenterprise development and have expressed little interest in funding any microenterprise finance activities. Many have recognized USAID's comparative advantage in this field and are looking to USAID to develop local institutional capacities in this area.

Discussions were held with the World Bank and the European Union to discuss their programmatic focus and interest in microenterprise finance development. (USAID staff and other informants stated that other donors have shown little interest in microenterprise development in WB/G.) The World Bank is concentrating on the macro-economic and banking environment and has no plans to fund any microenterprise activities. Any potential enterprise lending activities in which they might become involved would be limited to small and medium enterprises. The European Union has funded the three local NGOs which are currently in the process of merging as the Palestinian Development Fund. They informed us that they specifically are avoiding microenterprise finance in the future and are moving upmarket in their programs to address the lending needs of small and medium enterprises. They expect that the minimum loan size to be lent by the PDF will be ECU40,000 (more than $40,000).

The absence of other donor activity in the microenterprise finance field better allows for control of the process by USAID to apply lessons learned elsewhere without interference from other programs which have less stringent methodologies. In some other parts of the world, microenterprise finance programs based on sound methodologies have had to compete with programs providing subsidized credit and less disciplined repayment policies. This competition can limit the impact of a well-run microenterprise finance project. Prospects for the success of an USAID-funded microenterprise finance project are enhanced by the current lack of interest in this sector by other donors.

CHAPTER FOUR

REVIEW OF BEST PRACTICES IN MICROENTERPRISE FINANCE AND USAID MICROENTERPRISE SUPPORT POLICIES

A. USAID Criteria for Microenterprise Finance Project Selection

The Microenterprise Development Office of the Global Bureau of USAID helped to develop criteria for the selection of microenterprise finance projects and institutional mechanisms appropriate for USAID finance. The Bureau for Policy and Program Coordination subsequently issued a Microenterprise Policy Directive in late 1994 which presented the various criteria to be used by USAID Missions to select and implement microenterprise projects/programs. These criteria are based upon USAID's experience and other donor/NGO experience in microenterprise finance throughout the world.

The principal criteria dealing with microenterprise finance projects are summarized below.

Definitional and Developmental Context

- The definition of a microenterprise is set at ten or less employees with low levels of assets or income.
- Recognition that the developmental context is important to the success of a microenterprise development program (the economy and political conditions must be conducive to - or at least not impede - microenterprise development). Policy dialogue and encouragement of policy reforms in both the financial and nonfinancial sectors may be appropriate areas of activity of USAID-financed projects.
- The development of organizations/institutions to provide services to large numbers of the poor through support to microenterprises, both financial and nonfinancial, is promoted, with special emphasis on female entrepreneurs.

Financial Services

- Programs should target the poor through provision of small loans and acceptance of small deposits, through reliance on collateral substitutes and through appropriate credit and savings mechanisms.
- Program focus should be on the development of financial services through sustainable institutional mechanisms to provide microenterprises with long-term access to those

services even after USAID financing is ended. This requires that microfinance institutions (MFIs) plan to be financially sustainable through operational self-sufficiency over time with policies and procedures to cover the full opportunity cost of its activities. Critical aspects required to achieve self-sufficiency include full-cost-recovery interest rates and fees, control of loan delinquency and losses,

- MFIs must demonstrate that they are striving toward increased outreach both to reach greater numbers of poor microenterprises as well as to achieve sufficient scale for institutional self-sufficiency.

- Preference is shown toward MFIs which develop relationships with private sector financial intermediaries so that future program funds might come from those sources.

Other relevant sections from the Policy Directive and Guidance Document specify expected program results, reporting requirements, and discuss the advantages/disadvantages of dealing with NGO-run MFIs versus commercial banks. These are presented below.

Expected Program Results

USAID assistance to MFIs is expected to produce the following chain of results:

- the emergence of financially and institutionally sustainable MFIs both capable of and committed to serving the needs of poor microentrepreneurs, leading to
- a sustained expansion in the range, and improvement in the quality of key financial services available to poor entrepreneurs, and/or a permanent reduction in the prices of such services, contributing to
- increased incomes among the microentrepreneurs utilizing those services and their employees, and
- improved household welfare among the families of microentrepreneurs and microenterprise workers.

The extent to which these results are realized will depend on a wide variety of circumstances, only some of which are under the control of any given USAID-assisted MFI. (p. 20)

Reporting Requirements

The Policy Directive goes on to say (p. 21),

> Every Mission providing assistance to any organization that offers financial services to microenterprises will be held responsible for monitoring and reporting on two aspects of the results of that assistance: (1) the breadth and depth of the organization's outreach to the poor, as reflected in the size distribution of its loan portfolio (and of its deposit liabilities, where relevant) and the proportion of women among its clients; and (2) the organization's performance as a financial institution, including its progress toward financial sustainability and its operational efficiency.

Performance in these two areas are to be assessed on the basis of the indicators detailed in Annex 14 of this report.

> USAID officers managing microfinance assistance activities are expected to use these results indicators to track the performance of assisted organizations and to indicate the necessity for intervention if their performance lags. It is incumbent upon these activity managers to verify that assisted institutions are able to supply accurate information. In some cases, improvements in the assisted organization's management information system (MIS) may be necessary to ensure accurate reporting. In such cases, Missions should consider supporting such MIS improvements as part of their assistance package. Finally, Missions may be required to provide additional data as necessary to allow USAID to inform Congress and the public about the Agency's microenterprise development activities.

"Commercializing" Specialized MFIs versus "Downsizing" Private Banks

The following excerpts from the section of the Policy Directive entitled, "Identifying Promising Opportunities for USAID Assistance," (pp. 27-29) are particularly relevant to Mission decisions regarding support to existing NGO-run microenterprise finance programs versus support to develop a microenterprise finance program within one or more banks in the WB/G.

> In designing its approach to microfinance development and in choosing among potential partner organizations, the Mission should remain sensitive to the merits and challenges of two broad approaches: (1) helping specialized MFIs reach financial sustainability and commercial scale; and (2) encouraging commercial banks and other profit-making financial intermediaries to target poor microentrepreneurs as customers.
>
> In most cases, NGOs have played the principal role in the initial development of microfinance, establishing specialized MFIs for that purpose. Most exhibit a strong and enduring focus on the poor. However, managers and employees of some NGO-founded MFIs may find it very difficult to adapt to the

changes in organizational culture necessary to attain profitability.

Profit-making banks offer a variety of potential advantages, including a commercial outlook and relatively sophisticated financial skills. In addition, they are already operating on a financially sustainable basis, so that they mainly require relatively inexpensive technical assistance to move into microfinance, rather than large injections of grant funds.

Despite the advantages just cited, Missions must clearly recognize the serious challenges presented by such a "downsizing" approach....(Discussion of the various barriers to "downsizing" followed.)....Taken together, these barriers tend to limit the circumstances under which profit-making financial institutions will actively pursue the microentrepreneurial market. Two factors likely to contribute to such a shift are (1) a clear demonstration that the local entrepreneurial market offers opportunities for profit---typically in the form of a specialized MFI that has achieved profitability and commercial scale; and (2) a highly competitive market for financial services that forces financial institutions to search for new markets. <u>These considerations suggest the need to encourage both NGO and private approaches to microfinance development</u>, (underlining added) as well as the linkage of the policy environment in the broader financial sector to the long-term prospects for the development of microfinance.

Finally, Missions should note that opportunities to support microfinance are not necessarily limited to an either/or choice between NGO-sponsored specialized MFIs and private banks. Rather, they should be alert to opportunities to foster creative partnerships between banks and NGOs, combining the banks' financial management skills and links to broader financial markets with the NGOs' experience among, and focus on the poor.

B. Target Group Attributes, Financial Products and Lending Methodologies

Successful microenterprise financial institutions are those that are able to merge the development objective of increasing incomes and employment among the poor on a continuous and sustainable basis, with the financial objective of recovering costs and earning a return sufficient to attract commercial sources of funds to ensure institutional sustainability.

The development of an efficient microenterprise finance institution requires the identification of **target group attributes** based on economic as well as equity concerns, the design of **financial**

products that respond to their needs, and the implementation of **methodologies** to deliver those products.

Target Group Attributes

Microenterprise finance institutions target the poor. Targeting the poor is a central component of USAID's microenterprise initiative and satisfies both equity and economic development objectives. Large numbers of microenterprises not served by any formal or semi-formal institutions are able to support the full costs of delivering them loans on a sustainable basis. Alleviating the constraints to microenterprise access to resources enables hundreds of thousands of low income households to increase their incomes.

Microenterprise institutions serve both men and women borrowers. An implicit objective of USAID's microenterprise initiative is to provide access to financial and other resources to underserved populations. Though women operate the majority of all microenterprises worldwide, they often face greater constraints in accessing needed resources. Because of the large numbers of women microenterprise operators, microenterprise finance is an effective way to assist women overcome economic and social constraints.

Target groups should be large enough for the lending institution to achieve scale. Microenterprise lending institutions worldwide need a critical mass of borrowers in order to be able to recover all of the costs of lending at reasonable rates of interest. With a critical mass of 2,000 to 5,000 borrowers an efficient microenterprises lending activity should be able to recover its costs at interest rates of 35% or higher.

Target groups should show preference toward existing enterprises. More important to the success than scale, is repayment. There is no guarantee that a borrower will be able to repay a loan, but established businesses that have been in operation for at least one year have a much higher probability of repayment than do new ones. Donor efforts to use microenterprise lending programs to assist populations with no prior business experience have very poor success rates. Although some well-run village banking microfinance programs in other parts of the world finance a high percentage of start-ups, inexperienced entrepreneurs add a greater level of risk to successful program implementation.

Target group selection should be flexible enough to encourage growth and expansion of microenterprises. Lending that allows good borrowers to expand while remaining clients of the microenterprise finance institutions, rather than 'graduating' them out of the program, strengthens repayment rates. A number of successful microenterprise programs focus on small loans, keeping the majority of their loans and average loan size small while making a smaller number of larger loans to proven clients, thus enabling their borrowers to expand. A final advantage is that programs that only serve very poor borrowers must charge higher interest rates, while programs that serve a broader spectrum of microenterprises can spread their costs over larger loans.

Financial Products

Successful target group orientation requires the design and delivery of a few simple products that meet the needs of the target group. The products offered by a microenterprises finance institution need to respond to the needs of the clients of the program, and be deliverable on a cost recoverable basis. Savings and credit are the two financial services used by all microenterprises.

Savings is an important service to microenterprise operators as well as a means to capitalize the microenterprise finance institution. The most noted success of a microenterprise finance institution using savings to capitalize its lending operations is the Unit Banking System of the Bank Rakyat Indonesia (BRI). The credit union movements - particularly in Latin America, the Caribbean, and some African countries - have also been successful at capitalizing 100% of their credit activities from client savings.

Most microenterprises do not save in formal institutions. The reasons for this are due to a combination of factors which may include: lack of confidence in the formal financial sector, high transaction costs of depositing and withdrawing savings, limits on the accessibility of deposits. Deposit programs must offer the following for low income households to move their savings into a formal financial institution:

- security;
- accessibility,
- at low cost.

Microenterprise Credit instruments need to be designed taking into consideration both the needs of targeted borrowers and the costs of delivering services to them. Below are a simple set of loan products that are delivered by successful microenterprise institutions.

> **Short Term Working Capital Loans** are the foundation of microenterprise lending. Because microenterprise loan sizes are very small relative to commercial bank portfolios, different methodologies need to be used to evaluate the credit-worthiness of borrowers. Short loan terms, with regular payments, address cashflow and working capital needs of microenterprises, while minimizing lenders risk exposure.

Incrementally Increasing Loan Sizes are another important element of most successful microenterprise finance institutions. As microenterprise operators go through several borrowing cycles and their businesses expand, so do their needs for capital. Borrowers who have successfully repaid several loans present a lower risk to the lender. Keeping lower risk borrowers by granting them successively larger loans spreads and minimizes portfolio risk to the lender. As the loan size increases, the unit costs of delivering those loans falls. Mixing very small loans with a smaller number of larger loans enables the lender to spread costs over a larger portfolio. Most successful microenterprise finance institutions that have lifted their loan ceilings still require that all borrowers start with lower loan amounts borrowing incrementally larger amounts with successive loans.

Fixed Asset Loans aid microenterprises to expand as their needs for capital formation require the purchase of equipment and machines. Since the amortization or payback period for these types of investments may require several years, these purchases cannot be financed by short-term working capital loans. Fixed asset lending requires some changes in the lending methodology, including utilizing collateral as a guarantee for repayment. <u>It is recommended, however, that microfinance programs only consider longer-term, fixed asset lending after they have had some years of experience in working capital loans</u>. Although some successful microenterprise programs have offered fixed asset loans, most have tended to concentrate on working capital loans and have tried to graduate expanding microenterprises into the formal banking sector which is more accustomed to collateral-based lending.

Methodologies

Numerous methodologies have been successfully developed and tested by microenterprise finance institutions worldwide. They all share the following principles:

- Reduce the cost of evaluating the loan request by emphasizing character-based, not collateral-based or project-based lending;
- Set interest rates or fees high enough to cover all costs of lending including the opportunity cost of borrowed funds and provision for bad debt loss;
- Minimize loan portfolio management costs by standardizing products;

- Minimize portfolio risk by starting borrowers out with relatively small loan amounts and gradually increasing loan size as borrowers establish a positive credit history;

- Emphasize short-term credit with regular (weekly or monthly) payments to encourage money management and to allow for constant monitoring of loan repayments;

- Build strong incentives for repayment using access to larger loan sizes with shorter processing times, group guarantees, and severe and rapid sanctions in case of borrower default.

The above elements can serve as principles for the design and delivery of microenterprise financial services. Use of solidarity groups, village banks and individual lending are some of the lending strategies used by successful microenterprise finance institutions. Some methodologies provide training to clients in basic business skills or in basic financial management skills; others use a stricter, minimalist credit approach providing only basic lending services. Whether or not training is provided or whether the same methods are used to lend to men and women, all have to be decided in the cultural context in which the microenterprise program is designed.

Application of the elements above are essential to the operational success of any microenterprise finance institution. Institutional sustainability,however, demands more. Sustainable delivery of microenterprise finance requires a secured supply of funds adequate to the needs of the microenterprise sector. Commercial sources of funds are the <u>only</u> sure sources of funds adequate to the needs of the microenterprise sector, and available for the long term. While a very small number of microenterprise finance NGOs are so successful at marketing themselves to donors that they have not had to consider commercial sources of funds, few microenterprise finance institutions have any chance of becoming sustainable without them.

The banking sector is the principal commercial source of funds available for financing microenterprises. The **development of strong linkages to the commercial banking sector** is the most reliable means of providing long-term access to funds for microfinance institutions. There are several reasons to support these linkages:

- To date few NGO-run microenterprise finance institutions have succeeded in scaling up and expanding services to meet demand, whereas, many banks financing microenterprises have already achieved economies of scale and have more than adequate liquidity to finance the microenterprise sector;

- Commercial banks are held to strict practices ensuring the prudential supervision of depositor funds; NGOs are not as stringently regulated, and to date, there are none that operate completely independent of donor funds;

- Commercial banks are able to minimize overall risk for their depositors by maintaining a highly diversified portfolio; NGO-run finance institutions often tend to concentrate their portfolio in a single bundle of assets, i.e., short term microenterprise loans.

Unfortunately, strong linkages to the commercial banking sector have been difficult. NGOs have much more willingness and experience in lending to microenterprises. In spite of very successful microenterprise lending activities managed by NGOs, bank willingness to participate in microenterprise lending often depends on factors external to the performance of microfinance borrowers.

C. Institutional Options

Worldwide, there is an wide array of institutional options that have been successfully used to deliver microenterprise financial services in a cost effective manner. The principal types of organizations that provide services to microenterprises are classified below.

Non-Governmental Organizations

- International organizations (often called Private Voluntary Organizations or PVOs by USAID)
- Domestic organizations without formal ties to international organizations (including cooperatives, credit agencies, social welfare associations, etc.)

Financial Institutions

- Banks
- Credit Unions

The strengths and weaknesses of each type of organization are discussed below.

Non-Governmental Organizations

Non-Governmental Organizations (NGOs) or Private Voluntary Organizations (PVOs), have the greatest experience providing financial services for microenterprises. NGOs are either international such as CARE, Catholic Relief Services (CRS), or Save the Children Federation (SCF), or are indigenous organizations which have evolved in response to articulated needs in the community.

In the field of microenterprise finance NGOs have gained considerable experience in the cost-effective delivery of financial services (mainly credit) to microenterprises.

Two weaknesses of NGO-run MFIs are their dependence on donor funds and high administrative cost structures, creating conflicts between a mission committed to alleviating poverty on one hand, and a need to achieve sufficient cost-recovery on the other.

International Organizations

A number of international NGOs have gained considerable experience and success in delivering financial services to microenterprises in a cost-effective manner. ACCION, Save the Children Foundation (SCF), CARE, Calmeadow Foundation, and the Foundation for International Community Assistance (FINCA), are just a few of the international NGOs specializing in the field of microenterprise finance.

Most of these NGOs are quite successful at accessing donor funds to support the costs and capitalization of their microenterprise finance activities. Their commitment to helping the poor has enabled them to experiment over time to develop effective lending methodologies.

High central overhead and administrative costs makes it difficult for many international NGOs to become sustainable. Dependence on donor funds has made it difficult for most NGO-run MFIs to become sustainable, or to scale up to serve a significant percentage of the microenterprise market.

Domestic Organizations

A subset of NGOs are local organizations led by respected business leaders. USAID and other donors have successfully developed partnerships with these types of organizations in the Dominican Republic (ADEMI), Egypt (the Alexandria Business Association, the Egyptian Small Enterprise Development Foundation), and Kenya (Kenya Rural Enterprise Program (K-REP). These partnerships evolved after an understanding was reached that both the donors and the local organizations had a common focus and purpose.

Financial Institutions

Banks

Banks are attractive partners for providing credit and savings services to microenterprises for several reasons. Banks generally have an established infrastructure of offices and personnel, and have profitability as an integral part of their business philosophy. Their diversified portfolio minimizes the savings risk to borrowers. Because banks are regulated by central bank authorities, they generally are well managed.

While they generally appear as strong candidates for delivery mechanisms for microenterprise credit, they are often hampered by a lack of interest in and knowledge of the techniques necessary to achieve cost recovery in a microenterprise lending portfolio. In developing countries commercial banks generally practice collateral-based lending, and are unfamiliar with and distrustful of character-based lending. Also, many commercial banks lack a cost structure or a branch structure that would enable them to deliver financial services to microenterprises in a cost-effective manner.

Credit Unions

Credit unions are cooperative financial institutions that provide savings and credit services to their members. Credit unions are highly democratic, not only with elected leadership, but with committee review of loan application and subsequent approval. Often, members of the credit unions are well known to each other. Credit unions are sustainable institutions lending out the surplus savings of some members to other members in need of credit for consumer or small business activities. Member savings are the foundation of credit unions since all credit union operate on self-generated capital.

Credit unions tend to be small and, in the absence of an apex organization, have difficulty meeting the credit needs of their members. Most credit unions lack a growth oriented strategy. The up-front technical assistance and training costs needed to build a sustainable financial system are very high. At the same time capital accumulation tends to be slow.

The table below summarizes the strengths and weaknesses of each type of institution in microenterprise finance programs.

Table 3 - Strengths & Weaknesses of Different Types of Institutions as Microfinance Institutions

Organizational Type	Strengths	Weaknesses
NGO (International)	- Committed to and experienced in cost-effective delivery of microenterprise credit; - Capable of mobilizing international experience in efficient microenterprise lending methodologies.	- High administrative cost structures; - Difficulty in scaling up and expanding beyond donor contributions;
NGO (Domestic)	- Knowledgeable of and accepted by the local community; - Relatively low administrative cost structures	- Generally multi-purpose and lacking strict financial discipline needed to effectively manage a microenterprise finance institution; - Handicapped relative to international NGOs in accessing donor and commercial sources of funds.
Banks	- Diversified portfolio minimizes risk to depositors; - Capable of mobilizing sufficient funds to scale up and expand microenterprise finance operations; - Authorized to mobilize savings which can be used to fund a microenterprise loan portfolio	- Cost structure poorly adapted to reach down to the microenterprise loan level; - Often not interested in extending financial services to the very poor.

D. Monitoring and Evaluation Issues and Indicators

Monitoring and evaluation is a requirement on all projects financed by USAID. Although much remains to be done in the area of microenterprise finance, particularly in terms of impact evaluation, there is a large body of knowledge as to which factors to look at in appraising the outreach and management capabilities of MFIs. In addition, there is an established technique for determining if the activities of the MFI are sustainable. The Mission should draw on these sources of knowledge in determining the project indicators, monitoring data and collection procedures and evaluation criteria.

Project Indicators

For project logframe purposes

These project indicators would be integrated into the Strategic Objective tree for the Mission. The proposed microenterprise finance project will fall under the USAID/WB/G Mission Strategic Objective No. 1, Expanded Income Opportunities. Indicators should be tied as much as possible to objectively verifiable numbers which are relatively easy to ascertain from sources (intermediary organizations) responsible for project implementation.

The Microenterprise Policy Directive presents an array of indicators, some of which might apply to the project logframe - particularly those dealing with outreach. The key indicators for project logframe purposes should be related to increased access to savings and financial services, rather than to the ultimate effect on household incomes and firm-level expansion. Some potential indicators include the following:

- Increased numbers and amount of loans outstanding
- Increased numbers and amount of loans disbursed
- Increased numbers and amounts of small saver deposit accounts
- Increased percentage of female clients
- Decreased per loan lending costs of the implementing institution
- Increased per loan staff efficiency ratios
- Increased funds from private, commercial sources for microenterprise finance lending
- Increased numbers of institutions engaged in microenterprise finance

For project reporting purposes

Other indicators would be used for project reporting purposes. The Policy Directive lists those indicators, many of which are data which would be used to analyze the loan portfolio as well as the efficiency and sustainability of the implementing institutions. That data will be required from project implementing organizations and must be a requirement in any agreement between an implementing organization and USAID. The list presented in the annex entitled, "Minimum Reporting for Microfinance Institutions" of the Policy Directive cited above must be required in any such agreement. (Most of those indicators are presented in Annex 14 of this report.)

Evaluation Issues

Much of the evaluation of an MFI and its outreach activities can be addressed through an analysis of the various items listed above or in Annex 14. However, issues as to the impact of the MFI on clients' businesses, households and communities are much more difficult to assess. The Microenterprise Development Office of the USAID Global Bureau advises Missions not to attempt to measure project impact directly for new microfinance projects, but to concentrate on the financial performance of the institutions providing microfinance. That office has let a multi-year contract to explore these issues and to come up with some uniform criteria for impact evaluations of microfinance projects. The Mission should seek guidance from the this office on this issue.

On the other hand, the recommendations of this team for a phased approach to project implementation (found in Chapter Five), include an evaluation of project progress after the first year of operation as an early assessment of what is possible, from an institutional standpoint. This should guide the Mission on the activities of the project from the second through fifth years. Other evaluations of specific programs of project implementing organizations should be programmed into the project design document.

E. Examples of Successful Microenterprise Finance Programs from Other Countries

USAID and some other donors, as well as many in the NGO development community have utilized the principles described above in the design and implementation of various microfinance programs around the world. Effective microfinance programs are now found in many countries and in different economic and cultural contexts. The success of these programs results from using similar target group attributes, institutional delivery mechanisms, financial products, and lending methodologies to increase access to finance for microenterprises.

The reader of this report is encouraged to read Annex 6, which contains detailed descriptions of some of the most successful microenterprise finance programs in the world in Egypt, Kenya, Indonesia, Bolivia and the Dominican Republic.

CHAPTER FIVE

PROGRAM GUIDELINES AND RECOMMENDATIONS FOR A MICROENTERPRISE FINANCE PROJECT IN THE WEST BANK AND GAZA

In setting out the parameters for work in the microfinance area, the Sector Assessment Team recommends that USAID/WB/G use the following guidelines. (Note: These guidelines should be considered outer bounds. Any given microfinance program may need to target itself more precisely, as, for example, SCF has focused exclusively on women. USAID should support market definitions coming from programs as long as they are consistent with the general parameters outlined here.)

A. Target Group Attributes

All microenterprises in the WB/G should be eligible to participate in any USAID-funded microenterprise lending program. There are at least 150,000 microenterprises in the West Bank and the Gaza Strip. A very conservative estimate for programmatic purposes would be to assume that 10% (15,000) of these enterprises would be interested in and eligible for microenterprise loans at the prices and conditions set by the lending institution. Fifteen thousand borrowers is more than sufficient for a microenterprise finance facility to reach scale. Acceptable sectors would include, trade, light manufacturing, service and tourism. Agricultural production loans are not encouraged however, because they tend to be riskier and require different lending methods to ensure high repayment rates. It would be acceptable for microfinance programs to make a small percentage of their loans to agricultural producers, provided that they are involved in the processing or adding other value to their agricultural products.

Eligible microenterprises should include all enterprises with ten or fewer employees with a priority given to those enterprises with 5 or fewer employees. The justification for using a definition of microenterprises that include 90% of all enterprises in the WB/G is to design a program that retains those low income micro-enterprises that succeed in expanding. Many microenterprises with fewer than 10 employees in the WB/G have over US$ 100,000 in capital excluding land and buildings. These capital-intensive enterprises are not part of the group targeted by a proposed microenterprise finance institution which would be aimed primarily at low-income entrepreneurs. There is no need to exclude these firms from a microenterprise program because the relatively small loan size, and the costs of accessing them will be more effective at rationing loans than an attempt to accurately screen businesses based on the value of their capital.

Program design and implementation should ensure women's access to financial services. Cost effective delivery of microenterprise loans to both women and men in the WB/G will require that methodologies for delivering loans take gender into consideration. For example, both UNRWA and SCF stated that women were more likely to participate in Solidarity Groups. These and other cultural factors need to be considered in program design.

Only established microenterprises should be eligible for loans. Businesses that have been in operation for a minimum period of time and operate on an established business site have a much higher chance of success and of repaying their loans than do start-ups. This would not exclude home-based businesses, provided that the operator can demonstrate that the business is an ongoing activity and has been in existence for some time. Programs may want to limit services to enterprises that have been operating for some specified minimum period, such as six months or one year. However, it would be acceptable for a small percentage of loans to go to start-ups if a program demonstrated an ability to handle start-ups effectively.

B. Financial Products

The recommended financial products are based on experience of successful microenterprise finance programs. Loan amounts and types of loans are based on our assessment of the financial constraints faced by microenterprises visited in the WB/G. The proposed upper limits on loans for the WB/G are somewhat larger than typical for microenterprise lending programs. This is because the level of overall prices, the cost of labor, and investment in inventory and equipment by many microenterprises in the WB/G is fairly high.

Two observations regarding microenterprise finance frame the proposed financial products listed below. First, the best incentive to repay a loan is assured access to further and larger loans. Second, short loan terms and frequent and regular payments make it easier to ensure high repayment rates. For any USAID microenterprise finance activity in the WB/G it is proposed that:

> **Short term working capital loans should be the foundation of the microenterprise finance intervention.** Small short term working capital loans correspond to the needs and scale of most microenterprises, while holding loan default risk to a minimum until each borrower establishes a credit history with the program. Initial loans could be as low as $100 for services aimed at the poorest clients, while maximum loans for better established clients would probably be in the range of $5,000. Loans might be offered at maturities of 3, 4, 6 or 12 months.
>
> **Loan Amounts would be incrementally increased for repeat borrowers.** Starting microenterprise operators on small loans gives them an opportunity to develop and prove their

management skills, while the microenterprise finance institution avoids taking on excessive risk by making large unsecured loans. As borrowers establish a positive repayment history the microenterprise finance institution can reduce lending costs by automatic authorization for borrowers with a strong repayment history.

Repeat borrowers would be able to access medium-term investment capital. In order for many microenterprises to grow, they need access to capital for the purchase of technology (machinery and equipment) that enables them to compete successfully in higher value markets. There still is very little evidence of microenterprises 'graduating' from microenterprise finance institutions to commercial banks. It is important therefore, that microenterprises that are expanding, continue to be able to access sources of capital needed for that expansion. It is proposed that programs may want to make available larger loans with longer terms for their most experienced clients with growth potential. Outer limits for such loans would be 24 months and up to $20,000.

Microfinance program clients should, at a minimum, be encouraged to save a regular amount at periodic intervals. Although savings services do not appear a major constraint in the WB/G, based on the impressions of the MSI team, many well-run microfinance programs require that their potential clients begin a regular savings program both to establish that they have the discipline to make regular payments and to become familiar with the banking system. The commercial banks in the WB/G have an extensive branch network and appear to be accessible for small scale savings. Both the SCF and UNRWA encourage their clients to open and maintain savings accounts in the commercial bank of their choice. This type of activity should be encouraged in USAID-financed programs.

C. Lending Methodologies

Considerable flexibility exists in the choice of appropriate lending methodologies to reach microenterprises. Methodologies are tools to reach a goal. As with the use of any other tool, there are principles that guide us in the selection of the most appropriate tools to achieve our objectives. In developing a microenterprise finance institution, the objective is to increase incomes and employment among the poor on a continuous and sustainable basis by recovering costs and earning a return sufficient to attract commercial sources of funds to ensure institutional sustainability. Solidarity groups, village banks, guarantors (co-signors), lending to groups or associations who on-lend to their members are all recommended tools to deliver credit to microenterprises on a cost effective basis.

The Sector Assessment Team recommends that:

Loans should be made to individuals. With some exceptions, lending to collectives has had poor results. Village banking models and solidarity group lending are ways to transfer loan management costs onto program clients. These models are most successful when loans are made to their individual members.

Lending should be based on character and peer guarantees rather than formal collateral. Collateral or equity-based loans are costly to evaluate and recover in case of borrower default. The assurance of continued access to credit motivates repayments better than the threat of repossession. While longer term fixed asset lending may require a combination of character and collateral to ensure recovery, microenterprise lending emphasis should be on the borrowers character and capacity to repay, not on her/his collateral.

Linkages should be made with banks or other financial institutions to ensure sustainable access to adequate loan funds. Such linkages should involve the use of bank funds as a source of loan capital. These linkages can take a variety of forms, such as NGOs borrowing from banks, or NGOs acting as agents for banks. Commercial banks are not yet interested in providing loan services to microenterprises; NGOs do not yet show much potential for being able to expand to serve the tens of thousands of potential microenterprise borrowers. Rapid expansion of the banking sector means that there will be tremendous competition for deposits and services. Commercial bank funds are the only alternative to donor funds observed in the WB/G that could reach a significant share of the microenterprise market. USAID should exploit opportunities as they arise to assist the commercial banking sector reach down to microenterprises. For example, partial guarantees from USAID may be necessary to initiate linkages between banks and NGOs. Likewise, USAID should conduct workshops and study tours to acquaint bank officials with successful microfinance programs in other countries.

Interest rates be set high enough to cover all lending costs as the microenterprise finance institution reaches scale, after a reasonable start-up period. Lending costs include the opportunity cost of borrowed funds, provision for bad debt losses and all administrative and operating costs.

Any client training should be limited to what is necessary to ensure efficient operation of the lending mechanism. Solidarity group lending and village banking systems both have higher up-front client training costs but are effective at reducing the administrative and follow-up costs of maintaining the microenterprise lending portfolio. Training versus operational cost trade-offs need to be made. The guiding objective is to reduce the costs of delivering financial services to the poor on a sustainable basis.

D. Legal and Policy Framework

The Palestinian Monetary Authority (PMA) is supposed to emerge as the central monetary authority for the WB/G. It has just been formed and is dealing mainly with macroeconomic and macrofinance issues. Local banks and NGOs are not hampered by interest rate ceilings. Jordanian owned banks are under the supervision of the Central Bank of Jordan, and the Palestinian banks are, ostensibly but not practically, under the supervision of the PMA.

The International Monetary Fund is providing assistance to the PMA to help establish a central bank supervisory authority, although guidance and structure is still preliminary. There is not, at present, any definitive guidance, rules, or regulations regarding either NGOs or banks with respect to microenterprise lending. There is currently some discussion about capping the amount of deposits that Jordanian banks can place in Jordanian government paper. If this were to occur, increased local reinvestment of savings deposits might lead to banks reaching down to provide credit services to small and microenterprises. However, this is purely speculation at this point in time.

In summary, the policy framework is characterized by the following:

The Palestinian Monetary Authority, while formed, is not yet in a position to exert supervision or control over the banks operating within the WB/G. Arab Bank has lent some staff to the PMA to assist in supervision, but the PMA is not yet functioning as a Ministry of Finance or Central Bank. Banks operating in the WB/G that are Jordanian owned must comply with Central Bank of Jordan guidelines.

There are not yet any formal rules or regulations guiding NGOs or banks in microfinance.

This current lack of policy framework should be seen as an advantage to establishing or expanding microenterprise finance programs. There are not any current policies, laws, or guidelines that would restrain organizations from setting interest rates on deposits or loans that would be sufficiently high to recoup the transaction costs involved.

The sector Assessment Team recommends that,

USAID should monitor PMA actions that would affect the microfinance market. Although USAID may not want to take a direct role in macroeconomic policy issues, it should monitor potential changes in policy that could affect microenterprise development. Although the current lack of regulations offers some opportunities for greater flexibility in microfinance program development, this could change. USAID should be ready to advise against any policies which might negatively affect any microfinance activities.

USAID should work closely with those organizations advising or promoting policy changes through the PMA. USAID should maintain close contacts with representatives of the World Bank and IMF to assure that they are aware of USAID's interest in the microfinance sector and seek counsel from USAID on any potential policies which might aid or hinder microenterprise development and microfinance programs.

USAID should establish and maintain close contacts with key officials in the PMA and involve them in any educational or informational activities to promote microfinance. PMA officials should be encouraged to participate in any workshops or study tours on microenterprise development or microfinance. This would assist those officials to better understand the dynamics of the microenterprise sector and to promote policies which would improve the prospects for microenterprise development and microfinance.

E. Institutional Mechanisms

Alternative Institutional Options

There are basically three institutional options open to USAID regarding a microfinance project: existing NGOs, existing or new commercial banks, or a new hybrid organization. The third option has been added since the first draft of this report in order to provide USAID with greater flexibility in implementing a long-term strategy. These three options are discussed below.

Existing NGOs

One can count the NGOs currently involved with microenterprise finance on one hand. Only two organizations, Save the Children Federation and the United Nations Relief and Works Agency (although UNRWA is technically not an NGO) have any real experience providing services to the microenterprise sector. They are both showing some promising, if preliminary results. Two other NGOs, CARE and American Near East Refugee Aid (ANERA), have just launched credit programs for microenterprises. These programs might prove to be useful partners for USAID in the near future, as USAID begins to provide larger assistance to the microenterprise sector. None of the business organizations in the WB/G (which consist mainly of local Chambers of Commerce) appear to be viable institutional mechanisms for microfinance at present.

Existing or New Commercial Banks

The banking system has grown rapidly over the past two to three years, and bank managers have indicated plans of further expansion of services in the near future. In spite of excess liquidity, the banks have yet to directly engage the microenterprise sector, aside from providing passbook and current account services to small depositors. However, there are examples of cooperation with the NGOs noted above where the banks are handling cash for the NGOs and their borrowers; some of those banks as well as a few others indicated limited interest during interviews in expanding their loan products to the microenterprise sector.

In addition, the National Development Bank of Egypt informed us during a visit to Cairo that they were currently in the process of establishing a joint venture bank in Gaza with some Palestinian investors. They have been operating a large microenterprise finance program in Egypt over the past five years and stated that they might be interested in bringing the same methodology to Gaza and the West Bank. The NBD would be a strong candidate for support from USAID if the contemplated bank is eventually established.

A New Hybrid Organization

This could be an organization similar to the foundations in Egypt or another type of organization. It could either an existing institution like a business association, but would more likely be a newly created organization specifically for the purpose of implementing a microfinance program. This institutional vehicle might appear during the first year of a microfinance activity by USAID or it could be the result of a Request for Proposal by the Mission. In any case, it would probably be an amalgam of an NGO and a financial institution. This third alternative gives the Mission another institutional option if the results of the activities of existing NGOs were unsatisfactory or if a commercial bank does not come forward to champion microenterprise finance.

Recommended Institutional Strategy

There are positive and negative factors in dealing with either NGOs or commercial banks. The NGO community generally has considerably more flexibility in establishing a new program, but has inherent problems in achieving scale and financial independence. The banks which now exist in the WB/G area have the structural capability for carrying out widespread coverage, but lack the methodology and the will to carry out microenterprise lending at present. Currently, only the international NGOs are conducting any microenterprise lending, and that activity is on a very limited scale, with a total of less than 1,000 borrowers. Furthermore, only the international NGOs have demonstrated the capability and interest in providing services to the microenterprise market, but others may emerge in the near term.

Given the newness of microenterprise finance in the WB/G, USAID should keep all three options open - funding pioneer activities by existing NGOs, engaging the banks to broaden their loan portfolio downward, and identifying a possible hybrid organization. This is consistent with the approach espoused by the Microenterprise Development Office of the Global Bureau and recognizes the dangers of placing too much faith in the commercial banking sector to take prime responsibility to develop a microenterprise finance program as a long-term option.

F. Sources of Microfinance Funds

The number of donors active in microenterprise finance is very limited. In fact, except for some small experimental funds in the World Bank in Washington (CGAP), USAID is clearly the only donor in the WB/G who appears interested in the sector at all at this point. This might change in the medium term, however.

The table below shows different potential sources of funds for a microfinance program in the WB/G at this time.

Table 4 - Sources of Funds for a Microfinance Program in the West Bank and Gaza *

FINANCING SOURCES	Loan Capital Funds	Start-up Institutional Costs	Operational Funds
Private Investors	Low	Low	Low
Bank Funds	High	Low	Low
Lending Reflows and Other Interest Income	Low (early) High (late)	Low	Medium (early High (late)
Donors			
USAID	High	High	High
Others	Low	Low	Low

* High means a likely source of funds, Low means an unlikely source of funds.

As the table shows, USAID is the only real source of start-up funds for a new microenterprise program or activities on any large scale. Banks are a strong potential source of funds for loan capitalization and reflows from microlending operations would be a good source of both loan capitalization and operational funds later on in project implementation (years 3 - 5).

G. Programming Strategy

The Sector Assessment Team recommends that USAID implement a two-phase program. The first phase would begin immediately and run approximately one year. The second phase would run for four years at the end of the first phase.

Phase One

The major activities of Phase I would be:

- Funding for the expansion of a maximum of 3 existing NGO microfinance programs;

- Engagement of the formal banking sector to assess interest in a microfinance facility and to identify individuals either in the banking sector or the business community who might be interested in championing the creation of a microenterprise finance program;

- Conducting a seminar for key individuals in the banking, NGO and business communities who are interested in the concept of microfinance; followed up by visits to successful programs in other countries for those individuals who demonstrate the most interest in microfinance during the seminar;

- Technical assistance to banks or others who are interested in developing a microfinance program and to NGOs who may have received grants for expansion of their programs, and

- Exploration of the feasibility of an alternative, hybrid organization which could implement a microfinance program.

Phase Two

The major activities of Phase II would be:

- expansion of financial services,

- participation by a commercial bank or a hybrid organization,

- finance of continued short-term technical assistance to selected NGO-run MFIs,

- continued capitalization of loan or guarantee funds of well-run MFI programs, if necessary,

- financial support of program start-up costs for financial institutions committed to a microfinance facility, and

- long-term technical assistance and training for facilitating the development of a microenterprise program run by a commercial bank or a hybrid organization, designing and implementing training programs and short-term TA, and monitoring project progress by both banks and NGOs.

H. Program Components

Institutional Support

The project would provide support to various alternative institutional vehicles, depending upon the results achieved during Phase I. At the end of Phase I, USAID/WB/G should evaluate the performance of the NGOs receiving assistance during Phase I and determine the indicated level of continued support. Concurrently, one or more commercial banks should have been identified for the development of a microenterprise finance facility. If there were no interest by a commercial bank in the establishment of a microfinance facility, the Mission would consider a possible hybrid organization. At that point, the Mission would determine the most effective means of creating that hybrid organization, including the issuance of an RFP that would specify the type of hybrid organization desired. The RFP would request proposals from various firms and NGOs on how they would go about creating that organization and implementing a microfinance program.

Commercial Bank

If feasible, Phase II would focus on developing the capacity of a commercial bank to establish a microenterprise finance facility. The selected bank must be committed to support the full costs of this facility and operate it as a profit center by the end of the USAID funded activity.

Technical assistance, operating cost support, and/or partial guarantees would be provided on a cost and risk share basis with the selected bank. USAID should support a declining share of the microenterprise finance facility's operating expenses until the facility becomes operationally self-sufficient, at which time USAID's contribution would drop to zero.

Support to a commercial bank does not exclude a commercial bank-NGO linkage. During the second phase of the project, a decision could be made whether to promote direct lending by a commercial bank or bank linkage to an NGO, or both.

NGOs

During the first phase of the project, USAID would enter in grant agreements with a maximum of three NGOs to expand their existing or new microfinance programs. NGOs would be selected for grants based upon the following criteria.

- A clear description of the microenterprise target group to be reached,

- A financial plan that demonstrates cost recovery and institutional sustainability within 3 to 5 years, after which further operational support would not be required,

- Lending and savings methodologies that are consistent with the USAID Policy Directive on Microenterprise Development, and

- A stated willingness and capability to efficiently monitor and report loan portfolio performance.

During the second phase of the project, USAID would concentrate its support on those NGOs demonstrating the most promise for achieving full cost recovery. This phase of the proposed activity would include continued technical assistance, and increased capitalization of loan or guarantee funds, if necessary. It is expected that any supported NGO would achieve full cost recovery by the end of the project and be able to expand without continued USAID support at that time. As previously mentioned, this can only occur if linkages have been established between the selected NGO(s) and one or more commercial banks (or other source of private finance).

Hybrid Organization

As previously stated, this organization would probably be an amalgam between an NGO and a financial institution. The decision on whether or not to create this organization would be based upon an assessment of the feasibility of implementing a microfinance project through a commercial bank at the end of Phase I. If the commercial bank option was not feasible, this hybrid organization would provide a fallback option for the Mission.

Technical assistance, operating cost support, capitalization of loan funds, and/or guarantees would be provided on a cost and risk share basis with the selected hybrid organization. USAID should support a declining share of the microenterprise finance facility's operating expenses until the facility becomes operationally self-sufficient, at which time USAID's contribution would drop to zero.

Financial Services

The financial services component of the proposed activity will focus on improving and expanding loan services, and selecting and assisting the most appropriate institutions to deliver microenterprise financial services in the long run.

Refining Lending Methodologies

Early in the second year of the proposed project, a rapid assessment of the performance of the various microenterprise lending programs should be conducted. The purpose of this assessment would be to determine whether to continue, modify or abandon individual methods of delivering and recovering on microenterprise loans. An evaluation of financial performance and progress toward financial viability would be a critical part of this assessment. At the same time, an assessment of the training needs of credit institution employees and clients would be made. Appropriate actions would be taken based on that assessment.

Increasing Outreach and Sustainability

In addition to expanding services to existing clients of USAID supported NGO microenterprise finance institutions, these institutions should make significant progress in expanding their operations to reach increasing numbers of new clients. Given the size of the market and estimated demand, USAID supported programs should reach operational self-sufficiency in three years.

Non-Financial Services

As the existing political and infrastructure constraints resulting from occupation are alleviated, non-financial constraints may surface that limit the growth and expansion opportunities for microenterprise operators. A brief assessment of microenterprise constraints is proposed for year two or three to determine whether or not non-financial services targeted to microenterprises is indicated.

Interviews of microenterprises in trade, textile manufacturing, light manufacturing and services indicated that the major non-financial constraints to enterprise growth are the political and infrastructure constraints resulting from occupation. Constraints to the free movement of labor and goods, lack of access to international input and product markets, and unresolved industrial development issues directly or indirectly impact microenterprises.

When these constraints are alleviated it will be appropriate to determine whether (1) there are significant non-financial constraints limiting growth and expansion of microenterprises; and if so, (2) whether there are appropriate and cost-effective means of alleviating those constraints for large numbers of microenterprises.

Assessment of non-financial constraints to microenterprise growth is proposed for some time in year three of the proposed activity. A subsector assessment of 1-3 key subsectors that engage large numbers of microenterprises is proposed. Based on this assessment USAID would determine whether and what type of non-financial intervention is indicated.

I. Training and Technical Assistance

During Phase I, project training and technical assistance would be largely short-term. Mission staff would contract with firms to conduct a microfinance workshop and study tours. Mission staff would be responsible for the identification of potential banks or hybrid organizations for participation in the creation of a microfinance facility during Phase II.

Should the creation of a microfinance facility in a commercial bank or a hybrid organization prove to be viable, it is recommended that the Mission contract for long-term assistance during Phase II. The long-term contractor would guide the process of developing the methodology of microenterprise lending with the bank(s)/hybrid organization selected and guiding the process of the development of microfinance capacity within the institution. This long-term contractor would identify and facilitate short-term TA and training for both the bank(s) and NGO(s) as required. The contractor would also be responsible for project monitoring and assuring that USAID reporting criteria are fulfilled.

ANNEXES

ANNEX 1

SCOPE OF WORK

Microenterprise Finance Sector Assessment

A. BACKGROUND

The USAID Mission for Gaza and the West Bank intends to design a new project activity in the area of microenterprise finance, for FY 1996 Authorization. Currently, USAID provides assistance to a number of projects supporting the Small and Medium Enterprise (SME) sector. However, none of these projects are designed to directly address the financial needs of microenterprises.

As a result of frequent border closures and other factors, unemployment in the West Bank and Gaza exceeds 30 percent of the workforce. Underemployment is similarly endemic. Industrial capacity utilization is less than 60%, on average. GDP per capita has declined, in real terms, since 1987.

This deterioration of the economic environment has forced many displaced workers into the informal/microenterprise sector. Although very little census or survey data exists to quantify the magnitude of the microenterprise contribution to the economy of the territories, empirical evidence suggests that such enterprise make up a significant, and growing, portion of GDP.

There is no tradition of microlending within the formal banking system in Gaza or the West Bank. Two donor-assisted programs currently offering microcredit (Save the Children and UNRWA) report high demand and recovery rates. Based on this limited experience, it is assumed that the supply of microcredit is far below the latent demand.

The development hypothesis for a potential microenterprise project design is, therefore, that enhanced access to credit for microentrepreneurs will stimulate significant economic activity, alleviate poverty and create employment.

B. OBJECTIVE

The objective of the tasks described in Section C, below, is to assist USAID to assess the microenterprise sector in Gaza and the West Bank; to evaluate the potential demand for microcredit in the territories and the elasticity of that demand; and to recommend specific institutional arrangements for microcredit delivery drawing upon lessons learned in the implementation of similar programs in other development contexts.

At a minimum the sector assessment will address each of the following questions:

1. How do microenterprises in Gaza and the West Bank currently obtain financing?

2. What interest rates are charged for short-term capital from various sources? What is the price elasticity of demand for such credit?

3. What is the estimated magnitude of current and latent demand for microcredit in the territories, at selected interest rate and term variables?

4. Do microcredit supply/demand factors in Gaza and the West Bank justify USAID involvement in this sector? At what funding level?

5. What principal lessons have been learned in the design/implementation of microcredit projects in other parts of the world?

6. Are there cultural factors in Gaza and the West Bank that would limit the transferability of such lessons?

7. How would changes in the economic environment in the territories impact the projected demand for access to microcredit?

8. What beneficiary groups would stand to benefit from USAID involvement in this sector? To what extent?

9. How many permanent jobs would likely be created by USAID involvement in this sector?

10. How should project impacts be monitored/evaluated over time?

11. What system of data collection would be most appropriate for the purpose of impact assessment?

12. What institutional arrangements would be most appropriate for the implementation of a USAID-funded microcredit project?

13. Should USAID consider adding additional microenterprise support elements to the project design (e.g. training, technical assistance, "mentorship" programs)? If so, why? How might such ancillary components impact prospects for project sustainability?

14. Should USAID specifically target certain beneficiary groups (e.g. women)?

15. Should the project design include group guarantee features? Compulsory savings? Loan "cycles" with progressively higher credit limits?

16. Would the expected number of borrowers and the recommended implementation mechanisms allow for the achievement of operational efficiency (e.g. covering all administrative costs, the full commercial cost of capital, and loan losses, from client revenues within a period of three to five years)?

17. How should a USAID-funded microcredit project interact with formal financial institutions in the territories?

18. What is the extent of other-donor involvement in this sector? How should a USAID-funded initiative be coordinated with other donor agencies?

C. SPECIFIC TASKS

The sector assessment team shall carry out the following specific tasks:

Task 1: <u>Familiarization</u>

The team members will review relevant documents and background materials relating to USAID experience in microenterprise and microcredit projects worldwide. The collective experience of other donor agencies (including NGOs) should also be reviewed.

Immediately upon arrival in the field, team members will meet with the Chief of the Private Enterprise Support Office of USAID Gaza/West Bank and other USAID staff, as appropriate, for entry briefings and a review of the team's proposed methodology.

Subsequently, team members, individually or collectively, will meet with representatives of financial institutions and NGOs involved in small and microcredit delivery programs in Gaza and the West Bank. The team will concentrate efforts on those institutions with the highest potential for subsequent involvement in a USAID-funded microcredit project.

Task 2: <u>Assessment of Existing Micro-credit Programs</u>

The team will analyze and evaluate: 1) Save the Children's Group Guaranteed Lending and Savings (GGLS) program in both Gaza/West Bank and Jordan; 2) the UNRWA Solidarity Group Lending (SGL) program in Gaza; and 3) USAID/Cairo-supported microcredit projects in Alexandria and Cairo City. The team's analysis will focus on strengths and weaknesses of each program; constraints encountered in implementation; delivery mechanisms adopted;

outreach, beneficiary impacts, sustainability and capacity for expansion. In addition, the team will examine other microcredit sources such as money lenders, extended families, supplier credits, etc., using approximately the same criteria for evaluation as those applied to the donor-assisted microcredit initiatives.

Task 3: Assessment of Demand for Microcredit

Demand for microcredit will be assessed using a methodology and sampling strategy discussed with and approved by USAID Gaza/West Bank. That methodology will clearly differentiate among different sized firms (within the spectrum of firms defined as "micro") and for different types of credit (e.g. loan size, term, group vs. individual lending, etc.).

Task 4: Scanning of "Best Practices" in Microcredit

The team will assess the applicability of lessons learned in the implementation of successful microcredit programs in other countries, with a particular focus on countries with similar market dynamics, income distribution, and economic environment.

Task 5: Implementation Mechanism

The team will analyze potential implementation options including, inter alia: a "stand alone" project facility managed by a contractor; a USAID-funded expansion of existing microcredit programs; an institutional linkage with formal banking institutions; a Cooperative Agreement or other contractual mechanism with an implementing PVO or NGO; or a grant to a business association or chamber of commerce. The team will develop a matrix depicting the various implementation options and outlining the strengths and weaknesses of each.

Ultimately, the team will recommend one or more specific options, describe the optimal mix of features to be incorporated into the project design and address related issues of staffing, overheads, public outreach, financial controls, management information collection and reporting and other such implementation parameters as may be appropriate.

Task 6: Debriefing

The team will conduct an oral debriefing and draft report review with USAID Gaza/West Bank senior staff and representatives of other agencies as determined by the Chief of the Private Enterprise Support Office.

Task 7: Report Submission

The team will prepare and submit a Final Report of the assessment that describes the findings of the team, in detail, and provides responses to the evaluation questions contained in Section B of this Scope of Work. The Final Report shall also reflect editorial and substantive comments arising during the draft report review. Ten hard copies of the Report will be delivered to USAID/Tel Aviv within two calendar weeks of the draft review, along with one or more diskettes containing all text, tables, figures and annexes.

D. PERIOD OF PERFORMANCE

The level of effort allocated for this assessment is six (6) calendar weeks for three (3) consultants, of which four (4) weeks will be spent in Tel Aviv/Gaza/West Bank. Approximately one week will be spent in Jordan/Egypt reviewing existing microenterprise support projects operating there. One week will be authorized for homeoffice familiarization tasks and report finalization. A six-day workweek is authorized.

E. TEAM COMPOSITION

To carry out this sector assessment, three expatriate consultants are required. A local-hire, Palestinian consultant will be engaged directly by USAID Gaza/West Bank and attached to the expatriate team to provide an informed local perspective on relevant issues and to facilitate interactions with Palestinian contacts in Gaza/West Bank. The three expatriate consultants should have the following qualifications:

1) A Microenterprise Specialist possessing

- At least ten (10) years experience in the design, analysis or implementation of small and microenterprise projects;
- Demonstrated prior experience on project design or assessment teams;
- Demonstrated prior experience performing economic analysis of projects and sector assessments involving statistical abstraction and data collection.

2) A Small/Micro Finance Specialist possessing

- At least ten (10) years experience as a financial officer implementing small or micro lending programs for donor-assisted or commercial credit facilities;

- Demonstrated prior experience in financial analysis, project design or project evaluation.

3) An Evaluation Specialist/Social Scientist possessing

- At least ten (10) years experience evaluating donor-assisted programs and assessing beneficiary impacts;
- Demonstrated prior experience designing USAID projects with a particular focus on project monitoring and management information collection/dissemination.

ANNEX 2

WORKPLAN

MICROENTERPRISE SECTOR ASSESSMENT

<u>Week of January 7 - 13</u>

(Entire team travels together and attends all meetings)

- Sunday: Team arrives in Tel Aviv
- Monday: Introductory briefings with USAID officials and arrangements of logistical matters
- Collection and review of relevant background and program documents
- Meetings with key banking institutions in Ramallah (Arab Bank, Commercial Bank of Palestine)
- Initial meetings with existing providers of credit to micro, small and medium enterprises in the West Bank and Gaza (EDG, TDC, ADCC, CD and UNRWA)
- Meeting with director of USAID-financed Small Business Support Project
- Friday: Preparation and submission of team workplan

<u>Week of January 14 - 20</u>

(Sunday - Monday:	Entire team in West Bank
Tuesday - Thursday:	Jensen & Abdel Shafi in Gaza, Kula in West Bank, Silcox splits time between both
Friday & Saturday:	Entire team in Tel Aviv)

- Further meetings with existing providers of credit to micro and small enterprises in West Bank and Gaza (Save the Children)
- Interviews with clients of existing providers of credit to microenterprises and SMEs in West Bank and Gaza (STC, UNRWA & ADCC, CARE).
- Interviews with selective, dynamic Chambers of Commerce and other business associations (Jenin and Nablus Chambers, Group of Industrialists in Bethlehem, Others to be determined)
- Interviews with key banking institutions and the Palestinian Monetary Authority in Gaza
- Interviews with other donors funding financial sector development and micro and SME finance
- Further collection and review of relevant background and program documents
- Preparation of discussion paper on preliminary findings and draft report outline
- Friday - 3pm: Meeting with USAID officials to discuss preliminary findings and draft report outline
- Saturday: Team meeting to determine individual responsibilities for draft report

Week of January 21 - 27

(Sunday - Thursday:	Wallach, Abdel Shafi, Silcox, Jensen in Egypt
Sunday - Monday:	Kula in West Bank
Tuesday - Thursday:	Kula in Gaza)
Friday - Saturday:	Entire team in Tel Aviv to review findings to date and to formulate and submit draft report outline)

Egypt Team

- Sunday: Travel to Egypt and briefings with USAID/Cairo officials
- Monday - Thursday: Interviews with USAID-financed credit providers to micro and small enterprises as well as selected clients (National Bank for Development, Credit Guarantee Corporation, ESEO - Cairo Foundation, and Alexandria Business Association)
- Thursday: Travel to Tel Aviv

Kula

- Sunday - Monday: Follow-up meetings with small and microenterprises in West Bank (including visit to Hebron)
- Tuesday - Thursday: Meetings with micro and small enterprise clients of UNRWA and Save the Children in Gaza and Gaza Chamber of Commerce

Entire Team

- Friday - Saturday: Drafting of team report

Week of January 28 - February 3

(Sunday - Monday:	Silcox & Kula in Jordan
	Jensen & Abdel Shafi in Gaza or West Bank
Tuesday - Saturday:	Entire team in West Bank, Gaza or Tel Aviv)

- Briefings with USAID officials in Amman
- Interviews with Save the Children, Jordan Loan Guarantee Corporation, and Near East Foundation in Jordan
- Follow-up interviews with institutions and organizations in West Bank and Gaza
- Drafting of team report and discussion paper on potential options for USAID in supporting microenterprise development
- Friday: Meeting with USAID officials to discuss potential broad options for microenterprise development

66

Week of February 4 - 10

(Entire team in Tel Aviv)

- Complete drafting of team report
- Tuesday afternoon: Submission of team report to USAID
- Thursday: Meeting with USAID officials to discuss draft report
- Friday: Team departs Tel Aviv for Washington

Submitted:	12 January 1996 Date	(Signed) Stephen C. Silcox Team Leader
Approved:	12 January 1996 Date	(Signed) Brad Wallach Private Enterprise Officer USAID/Tel Aviv

ANNEX 3

SCHEDULE

(BW = Brad Wallach, SAS = Salah Abdel Shafi, SS = Steve Silcox, KJ = Karl Jensen, OK = Olaf Kula & ET = Entire MSI Team)

January

4 Team meetings at MSI in Washington to review scope of work, discuss team responsibilities and handle administrative matters (ET)

5 Team departs Washington (ET)

7 Team arrives in Tel Aviv (early morning) (ET)

8 Briefings at USAID/Tel Aviv with Brad Wallach, introductions to other USAID officers, and discussions and arrangements of logistical matters (BW & ET)

Met with Jeffrey Feltman, Economic Officer, U.S. Embassy/Tel Aviv (BW & ET)

9 Team travels to Jerusalem (ET)

Met with Eyad Joudeh, Acting Director, and Sahir Dajani, Vice Chairman, Economic Development Group (ET)

Met with Nasser Shraideh, Area Director, Co-operation for Development (ET)

Met with Ibrahim Matar, Chairman, and Tewfic Habesch, General Manager, Arab Development & Credit Company (ET)

Team returns to Tel Aviv (ET)

Briefing by Christopher Crowley, Director, and Brad Wallach, Private Enterprise Officer, USAID (BW & ET)

10 Team travels to Jerusalem (ET)

Met with Khaled Ghabeish, General Manager, Commercial Bank of Palestine/Ramallah (ET)

Met with Sami Saidi, General Manager, Arab Technical Development Corporation (ET)

Met with Shukri Bishara, Regional Manager, and Joseph Nesnas, Head of Project Finance, Arab Bank/Ramallah (ET)

Met with Tim Smith, Project Director, Small Business Support Project (ET)

Team returns to Tel Aviv (ET)

11 Team travels to Gaza (ET)

Met with Salah Abdel Shafi, Private Sector Program Manager, USAID/Tel Aviv (SAS & ET)

Met with Mona Sarraf, Credit Officer, Solidarity Group Lending Program; Imad Abu-Dayah, Financial Analyst; and Bahjat Eid, Microenterprise Credit Program Officer; UNRWA (SAS & ET)

Team returns to Tel Aviv and drafts team workplan (ET)

12 Met with Brad Wallach & Salah Abdel Shafi at USAID to discuss and approve team workplan (BW, SAS & ET)

Arrangement of meetings and logistics for upcoming week (SS)

Team travels to Jerusalem (ET)

13 Day Off

14 Team travels to Nablus (ET)

Met with Mohamed Khaled, Assistant Program Manager, and Fawzieh Abu Hijleh, Credit Officer, North Office, Save The Children Federation (ET)

Met with Salah Masri, General Manager, Bank of Jordan/Nablus (KJ)

Met with a group of women from the Asker Refugee Camp participating in the Group Guaranteed Lending and Savings (GGLS) Program; followed by interviews with individual women about their enterprises at their business sites (ET)

Met with a group of women from the Tulkarem Refugee Camp participating in the Group Guaranteed Lending and Savings (GGLS) Program; followed by interviews with individual women about their enterprises at their business sites (ET)

Team returns to Jerusalem (ET)

69

15 Met with Mark Khano, Research Assistant, Palestine Economic Policy Research Institute (MAS) to discuss report on the Palestinian Banking Sector (KJ)

Arrangement of meetings and logistics for rest of week (SS & OK)

Telephone call to Khaled Al Naif, USAID/Amman, to discuss trip to Jordan and organizations to visit (SS)

Met with Bill Greenwood and Odeh Shedaheh of the DAI Small Business Support Project (OK)

SS & KJ travel to Tel Aviv, OK remains in Jerusalem

16 SS & KJ travel to Gaza

Met with Alex Pollock, Field Development and Planning Officer, UNRWA/Gaza (SAS, SS & KJ)

Field trip with UNRWA staff to interview loan recipients from the Solidarity Group Lending Program (SAS, SS & KJ)

Met with Khaled Shawa, Assistant General Manager, and Ihsan Kamal Shaushaa, Foreign Relations Manager, Bank of Palestine, Ltd. (SAS, SS & KJ)

Met with Rafael Jabba, Jr., Resident Advisor, Cooperative Housing Foundation/Gaza (SAS, SS & KJ)

Met with Djibril Natseh, Secretary of the Chamber of Commerce of Hebron (OK)

Met with Sulaiman M. Nemr Manager of the South Area Branches, Cairo Amman Bank (OK)

Met with Mohye S. Ahmad, Public Relations Committee and other members of the Hebron Chamber of Commerce (OK)

Met with Sahid Abughosh, Munther Badak, and George Rizik of the Bethlehem Group of Industrialists (OK)

Met with Jeries A. Qumsieh board member of the Holy Lands Handicrafts Cooperative (OK)

SS & KJ spend evening in Ashkelon, OK in Jerusalem

17 KJ with SAS in Gaza, OK in West Bank, SS in Tel Aviv

Met with Ziyad Abushaban, Manager for Gaza Branches, and Ghalib Hantoly, Regional Credit Facilities of Cairo Amman Bank in Gaza (SAS & KJ)

Met with Azzam Shawaa, Branch Coordinator, Arab Bank, Remal Branch, Gaza (SAS & KJ)

Planning for trip to Egypt and Jordan and logistical arrangements made for other team activities (SS)

Telephone call to Judith Brandsma, CGAP, World Bank, Washington, DC, to discuss CGAP communications with Brad Wallach regarding potential funding of microenterprise activities in the West Bank & Gaza (SS)

Met with Dr. Hisham Jaber, tile maker, Beit Almah, Ramallah (OK)

Met with Ali Abdallah, owner of Ali Esmine factory, plastics extrusion enterprise (OK)

Met with Jihad Ahmad, and Abdallah Abu Ahram, money changers, Ramallah (OK)

Met with Mohammed Khaif, owner of textile manufacturing factory that subcontracts with Israeli firms and a retail boutique in Ramallah (OK)

Met with Samer Al- Birawi, Executive manager, Beit el-Mal Holdings, Ramallah (OK)

Met with Tewfick Habesch and Farouk Ahram, Arab Development and Credit Company, Jersalem (OK)

Met with Randall Harshbarger, Field Office Director, Save the Children Foundation (OK)

Telephone interview with Jana Brooks YMCA, regarding YMCA's youth vocational assistance Project (OK)

Drafting & discussion of draft report outline (ET)

18 SS & OK in West Bank, SAS & KJ in Gaza

Met with Wafa Abu Sitta, Women's Credit Officer, American Near East Refugeee Aid (ANERA) in Gaza (SAS & KJ)

Met with Yusef Abu Eljedian, CARE, Gaza (SAS & KJ)

Met with Tom Neu, Director, ANERA (SS)

Met with Paul Sutphin, Consul and Economic Officer, Consulate General, Jerusalem (SS)

Met with Charles Shamas, Palestinian Trade Promotion Organization (OK)

71

Met with Hisham Al Khatib, Loan Supervisor , Economic Development Group, Jersalem, Beit-Hanina (OK)

Met with Mohammed Abu Hader, owner of the Wadi-Jos Laundry, Jersalem (OK)

Met with Jamal Abdel Latif, engineer-owner of Abdel Latif Gas and Stainless Products (OK)

Met with Halid Mohammed, owner of the Patisserie Suisse, bakery & restaurant, Jersalem (OK)

Team returns to Tel Aviv in afternoon

Team meeting to review meetings during past week and preliminary findings

19 Preparation of briefing document on preliminary findings for USAID (ET)

Presentation to USAID staff of team workplan, outline of draft report outline and preliminary findings (ET)

20 Day Off

21 BW, SAS, SS & KJ travel to Cairo, OK travels to Jerusalem

22 Briefing with Timothy Hammann, Charles Vokral, and Magdi Khalil of USAID/Cairo Office of Finance and Investment on microenterprise finance programs in Egypt (BW, SAS, SS, KJ)

Met with Abdel Fattah Salem, General Manager, and Mona Mubarak, Foreign Relations Officer, National Bank of Egypt to discuss their microenterprise lending program (BW, SAS, SS, KJ)

Met with Ahmad Abdel Salam Zaki, Chairman and Managing Director, Credit Guarantee Company for Small Scale Enterprises, and Medhat Hassanein, Finance & Banking Consultants International, Egypt (BW, SAS, SS, KJ)

Met with Ibrahim Matar and Thomas Neu of ANERA, Jersalem (OK)

Met with Anne Morris and Raed Maehlke of CARE, Jersalem (OK)

Met with Ahmad Samir Riyad, Arab Development and Credit Company (OK)

23 Met with Mostafa Yassin, Executive Director, Egyptian Small Enterprise Development Foundation, Egypt (BW, SAS, SS, KJ)

Met with Halim H. Halabi, Director DRC

Telephone interviews with John Lapp, MCC, Johnathon Evans Catholic Relief Services.

24 Met with Nabil El Shami, Executive Director, Alexandria Business Association, Small & Micro Enterprise Project, and Ezz El-Sharkawy, Senior Advisor, SME Development Project, Environmental Quality International, Egypt (BW, SAS, SS, KJ)

Met with Bahjet Eid Microenterprise Credit Officer, and Raja Jabber, Promotion Agent of UNRWA and borrowers from the Solidarity Group Lending Program (OK)

25 Met with Sherif Sabri, Branch Manager - East Cairo, Egyptian Small Enterprise Development Foundation (SS, KJ)

Met with Robert Norberg, ANERA board member, Hazem Ramadan, of the Arab Bank Raman Branch (OK)

Met with Hamad Al Abed, Issa Ari, Ibrahim Farid, Sami Laweiti, Board members, officers, and staff of the Agricultural Cooperative of Khan Younis (OK)

Met with Halima Abu Nasser, entrepreneur and member of the Al-Mjjed Feminist Association, Nussierat Camp, Gaza (OK)

Met with Mariam Zakurt Menbe, and Hanni Abu Daka of the Women's Free Thought and Culture Association of Khan Younis .(OK)

BW, SAS, SS, KJ & OK travel to Tel Aviv

26 Email communications with AID/Washington, Global Bureau, fixing of dates for team debriefings, and logistical arrangements at USAID/Tel Aviv (ET)

Team meeting to review progress and discuss workplan and logistics for upcoming week (ET)

27 KJ, OK & SS travel to Tiberias, SS continues on to Amman, Jordan

13

Telephone calls to Beth Rhyne about visit to Tel Aviv, to Khaled Al Naif (USAID/Amman) re schedule in Amman, and to Brad Wallach re team schedule through next Tuesday and visit by Beth Rhyne (SS)

28 Met with Mark Eldon-Edington, Jordan Field Office Director/Middle East Area Director, Save the Children Federation, Amman (SS)

Met with Mohammed Daqqaq, Coordinator, Quality of Life Project, Noor Al-Hussein Foundation, Amman (SS)

Met with Sameera Qadoura, consultant for SCF (and former employee of the Near East Foundation), for USAID-financed feasibility study of a community-based income generation finance scheme, Amman (SS)

29 Met with Hassan Morahli, Loan Officer, Queen Alia Fund for Social Development, Amman (SS)

Met with Khalid Al Naif, Regional Banking and Finance Advisor, USAID/Jordan (SS)

Met with Yousef Bazian, Regional Manager for West Bank and Gaza (and responsible for Loan Portfolio Guarantee Program, Cairo Amman Bank (KJ)

Met with Malek W. Khadder, Manager, Ramallah (and responsible for Loan Portfolio Guarantee Program in West Bank and Gaza), Jordan National Bank (KJ)

Met with Ibrahim Bashir, ADCC, Janine West Bank, and ADCC borrowers (OK)

SS, KJ & OK travel to Jerusalem

30 Met with Nagy Hanna, Principal Operations Officer, and Christiana Schmidt, Technical Consultant, West Bank and Gaza Resident Mission, World Bank (SAS, SS)

Met with Bettina Muscheidt, Technical Assistant responsible for credit agencies, European Union (SAS, SS)

Entire team travels to Tel Aviv

31 Met with Brad Wallach & Salah Abdel Shafi to provide verbal team progress report (ET)

Drafting of report & preparation for Friday's presentation (ET)

February

1 Preparation of discussion document for presentation of microenterprise finance activity options (ET)

2 Presentation to USAID staff on microenterprise finance activity options (ET)

Drafting of report (ET)

3 Day Off (Drafting of report)

4 Drafting of report (ET)

5 Drafting of report (ET)

6 Completion and submission of draft report to USAID (ET)

7 Review of draft report by USAID and Embassy/Consulate General staff

8 Final Debriefing with USAID and Embassy/Consulate General staff (ET)

9 Team departs Tel Aviv

ANNEX 4

LIST OF PERSONS/ORGANIZATIONS CONTACTED/INTERVIEWED

U.S. GOVERNMENT

USAID/Washington

Elisabeth Rhyne, Director, Microenterprise Development Office, Global Bureau, USAID

USAID/Tel Aviv

Christopher Crowley, Director
Brad Wallach, Private Enterprise Officer
Salah Abdel Shafi, Private Sector Program Manager

U.S. Embassy/Tel Aviv

Jeffrey Feltman, Economic Officer

U.S. Consulate General - Jerusalem

Paul Sutphin, Consul and Economic Officer

USAID/Cairo Office of Finance and Investment

Timothy Hammann
Charles Vokral
Magdi Khalil

USAID/Jordan

Khalid Al Naif, Regional Banking and Finance Advisor

NON-GOVERNMENTAL ORGANIZATIONS

American Near East Refugee Aid (ANERA)

Tom Neu, Director
Robert Norberg, board member
Wafa Abu Sitta, Women's Credit Officer, Gaza

Arab Development & Credit Company

Ibrahim Matar, Chairman
Tewfic Habesch, General Manager
Farouk Ahram
Ahmad Samir Riyad
Ibrahim Bashir

CARE
Anne Morris, Jerusalem
Raed Maehlke, Jerusalem
Yusef Abu Eljedian, Gaza

Catholic Relief Services

Jonathan Evans

Co-operation for Development

Nasser Shraideh, Area Director

Cooperative Housing Foundation/Gaza

Rafael Jabba, Jr., Resident Advisor

Economic Development Group

Eyad Joudeh, Acting Director
Sahir Dajani, Vice Chairman
Hisham Al Khatib, Loan Supervisor

Mennonite Central Committee

John Lapp

Save The Children Federation

Randall Harshbarger, Field Office Director
Mohamed Khaled, Assistant Program Manager, North Office
Fawzieh Abu Hijleh, Credit Officer, North Office

Technical Development Corporation

Sami Saidi, General Manager

YMCA

Jana Brooks

BANKS

Arab Bank

Shukri Bishara, Regional Manager
Joseph Nesnas, Head of Project Finance, Ramallah
Azzam Shawaa, Branch Coordinator, Remal Branch, Gaza
Hazem Ramadan, Raman Branch

17

Bank of Jordan, Nablus

Salah Masri, General Manager

Bank of Palestine, Gaza

Khaled Shawa, Assistant General Manager
Ihsan Kamal Shaushaa, Foreign Relations Manager

Cairo Amman Bank

Yousef Bazian, Regional Manager for West Bank and Gaza
Ziyad Abushaban, Manager for Gaza Branches, Gaza
Ghalib Hantoly, Regional Credit Facilities, Gaza
Sulaiman M. Nemr, Manager of the South Area Branches

Commercial Bank of Palestine/Ramallah

Khaled Ghabeish, General Manager

Jordan National Bank

Malek W. Khadder, Manager, Ramallah Branch

CONSULTANTS & PROJECT STAFF

DAI/Small Business Support Project

Tim Smith, Project Director
Kent Ford, Project Manager
Bill Greenwood
Odeh Shedaheh

DRC

Halim H. Halabi, Director

INTERNATIONAL DONORS

UNRWA

Alex Pollock, Field Development and Planning Officer
Mona Sarraf, Credit Officer, Solidarity Group Lending Program
Imad Abu-Dayah, Financial Analyst
Bahjat Eid, Microenterprise Credit Program Officer
Raja Jabber

World Bank

Nagy Hanna, Principal Operations Officer, West Bank and Gaza

Resident Mission
Christiana Schmidt, Technical Consultant
Judith Brandsma, CGAP

European Union

Bettina Muscheidt, Technical Assistant

RESEARCH ORGANIZATIONS

Palestine Economic Policy Research Institute, (MAS)

Mark Khano, Research Assistant

BUSINESS ORGANIZATIONS

Bethlehem Group of Industrialists

Sahid Abughosh
Munther Badak
George Rizik

Chamber of Commerce of Hebron

Djibril Natseh, Secretary
Mohye S. Ahmad, Public Relations Committee

Holy Lands Handicrafts Cooperative, Bethlehem

Jeries A. Qumsieh, Board Member

Khan Younis Agricultural Cooperative

Hamad Al Abed
Issa Ari
Ibrahim Farid
Sami Laweiti

Palestinian Trade Promotion Organization

Charles Shamas, Director

EGYPTIAN ORGANIZATIONS

National Bank of Egypt

Abdel Fattah Salem, General Manager
Mona Mubarak, Foreign Relations Officer

Credit Guarantee Company for Small Scale Enterprises

Ahmad Abdel Salam Zaki, Chairman and Managing Director

Finance & Banking Consultants International

Medhat Hassanein

Egyptian Small Enterprise Development Foundation

Mostafa Yassin, Executive Director
Sherif Sabri, Branch Manager - East Cairo

Alexandria Business Association, Small & Micro Enterprise Project

Nabil El Shami, Executive Director
Ezz El-Sharkawy, Senior Advisor, Environmental Quality International

JORDANIAN ORGANIZATIONS

Noor Al-Hussein Foundation

Mohammed Daqqaq, Coordinator, Quality of Life Project

Queen Alia Fund for Social Development

Hassan Morahli, Loan Officer

Save the Children Federation

Mark Eldon-Edington, Jordan Field Office Director and Middle East Area Director
Sameera Qadoura, Consultant

ANNEX 5

ANNOTATED BIBLIOGRAPHY

Ashe, Jeffrey, et. al., "Revolving Loan Fund Program Evaluation," Save the Children/ West Bank Gaza, 1992.

This evaluation analyzed SCF's micro and small enterprise lending program prior to the current emphasis on the group lending mechanism. It recommended that SCF could be more effective at reaching the poor and gain better portfolio performance by lending to poorer borrowers using the Solidarity Group Lending methodology.

Atari, Bassam M. and Carol Oman Urban, "Gaza Housing Project - Technical Assistance: Market Based Affordable Housing Finance Loan Terms," First Washington Associates/USAID Affairs Office for Gaza, November 1994.

Report describes the housing finance and commercial lending system in the WB/G and proposes US dollar loans based on 90 day LIBOR rate for housing construction and improvement loans. A program of capital grants is proposed for those unable to afford financing at market rates.

Blayney, Bob and James Cawley, "The Egypt Small and Microenterprise Project: Final Report April 1989 - June 1993," Environmental Quality International/National Cooperative Business Association/Urban Systems, Inc./USAID, September 1993.

Report analyzes and compares the performance of the Alexandria Businessmen's Association and the Egyptian Small Enterprise Development Foundation. Makes recommendations concerning management information systems and need for stronger and improved management of the ESED.

Butt, Gerald, <u>Life at the Crossroads: A History of Gaza</u>, Rimal Publications, 1995.

History of the Gaza Strip from pre-biblical to post-Intifada. This book provides an excellent description of the historical and cultural conflicts leading to the post-Oslo Accord period. Infrastructure problems, water rights, border closures are discussed in detail as well as proposed new infrastructure projects.

CARE International, "Reinforcing the Economy of Palestinians by Assisting Institutional Development (REPAID)," Project Proposal, 1995.

Project proposal outlines a microenterprise finance facility based on the Village Banking Model. Two levels of loans are proposed. Program proposes to target women.

Christen, Robert Peck, "Trip to Gaza and West Bank," Memorandum to Brad Wallach USAID/WB/G, December 1995.

Personal observations by Robert Christen on the financial and microenterprise sectors in WB/G and review of statement of work for microenterprise finance sector assessment.

Christen, Robert Peck, et. al., "Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microenterprise Finance Programs (Draft)," IMCC/USAID(CDIE), Washington, DC, 1994.

Desk study comparing and contrasting leading microenterprise financial institutions worldwide, and establishing criteria for the measurement of program outreach and sustainability.

Congressional Research Service, "Total Sector Allocation of External Assistance to the West Bank/ Gaza," Excerpted from unknown document provided by CARE/Jerusalem, August 1994.

Graph indicating reduction in US assistance to Palestinians through NGOs since a high in 1993 of 27 million dollars, to a projected US$8 million in 1995.

Creevey, Lucy and Olaf Kula, "Rural Financial Institutions, Economic Policy, Reform Programs and Agribusiness In Sub-Saharan Africa," GEMINI Technical Report No. 95, Development Alternatives International/USAID, 1995.

Report compares formal, informal and semi-formal financial institutions in four Sub-Saharan countries. Outreach, sustainability and efficiency criteria are used to assess institutions serving rural and microenterprise clients.

Cruz-Villalba, Fernando, "Annual Report: The Small & Microenterprise Project, June 1993 - December 1994," NCBA/EQI/USI/USAID, January 1995.

Update on status of same Egypt project reviewed by Blayney & Cawley in June 1993 (cited above).

Donor's Working Group on Financial Sector Development and Committee of Donor Agencies for Small Enterprise Development, "Small and Microenterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries (Draft), May 26, 1995.

This document provides some basic guidelines in the design and operation of SME finance projects and criteria for selecting intermediaries to provide finance based on tested principles of well-run microfinance institutions worldwide.

gl

Economic Development Group, "Profile of a Palestinian Credit Agency," 1995

Document describing the functions, targets and financial information of the EDG. Includes balance sheet, budgets and breakdown of loans by sector.

European Union, "European Union Assistance to the Palestinians," EU, January 1996.

Review of the various programs and activities funded by the European Union and its member countries in the WB/G.

Glosser, Amy J., The Creation of BancoSol in Bolivia. The New World of Microenterprise Finance - Building Financial Institutions, Kumarian Press, New York, 1994.

Description of the origins and current operations of BancoSol. Part of a collection of papers originally commissioned by the GEMINI project on organizational, institutional, and financial aspects of leading microenterprise financial institutions.

Holtman, M. and R. Mommartz, "Analyzing the Efficiency of Credit Granting NGOs: A Technical Guide," Interdisziplinare Projekt Consult (IPC), 1993.

Document proposes a methodology for analyzing microenterprise financial institution success at reaching target population, economic viability and sustainability. Models for calculating various measures of efficiency and costs are included.

Liedholm Carl, and Donald Mead, "The Structure and Growth of Microenterprises in Southern and Eastern Africa: Evidence from Recent Surveys," GEMINI Working Paper Number 36. DAI/USAID, 1993.

Paper presents results from three microenterprise baseline surveys and makes comparisons to date on microenterprise dynamics with microenterprises in Indonesia.

Mead, Donald C., Hillary O. Mukwenha and Larry Reed, "Growth and Transformation Among Microenterprises in Zimbabwe," Draft Report, DAI, 1993.

Paper summarizes results of a baseline microenterprise study conducted in Zimbabwe, and makes reference to baseline studies from other countries. Categorizes microenterprises as no, slow, and high growth, and describes characteristics of firms in each group.

Nakleh, Khalil, "Indigenous Organizations In Palestine: Towards a Purposeful Societal Development," The Arab Thought Forum, Jerusalem, 1990.

During the period of Jordanian control over the West Bank between 1948-67 there were dozens of rural savings and loan cooperatives established during the British Mandate. As of 1979 there were 321 cooperatives in the West Bank, 162 of which were savings and loan or credit union societies. Originally linked to the Jordanian Cooperative Organization, these cooperatives later depended on American support through ANERA.

The evolution of cooperative societies in the Gaza Strip differed from that of the West Bank due to Egyptian control of the area until 1967. As of 1991 there were only nine cooperatives in the Gaza Strip, none of which were savings and loans institutions.

Palestine Economic Policy Research Institute (MAS), Palestinian Banking Sector Statistical Review, Palestine Monetary Authority, June 1995.

This document provides an overview of the Palestinian Banking System as well as a wealth of statistics on the banking sector in the WB/G. This report was very helpful to the team in assessing the size of the banking sector and various levels of activity.

Palestinian Central Bureau of Statistics, Labour Force Statistics in the West Bank and Gaza Strip, May 1995.

This document provides much information on the characteristics of the labor force in the WB/G. The team found these statistics helpful in assessing the size of the microenterprise sector in the WB/G.

PLO/Government of Israel, "Protocol on Economic Relations between the Government of the State of Israel and the PLO, Representing the Palestinian People," April 29, 1994.

This protocol establishes the contractual agreement governing the economic relations between the two sides and covers the West Bank and Gaza during the interim period. It addresses issues such as import taxes and import policy, monetary and financial issues (including bank registration and the establishment of the Palestinian Monetary Authority), direct and indirect taxation, labor, agriculture, industry, tourism and insurance issues.

Roy, Dr. Sara M., et. al., "West Bank and Gaza Gender Assessment," Management Systems International/USAID, December 1994.

This report covered various issues dealing with the role of

84

women in the WB/G in the five broad sectors of housing, health, small and medium business and marketing/private sector, and democracy and governance. It was helpful in describing the special needs of women in the development of micro and small enterprises.

Save the Children Foundation, West Bank Gaza, Financial Reports and loan printouts on the SCF Solidarity Group Lending Program, January 1996

Series of documents describing SCF's Solidarity Group Lending Program in the West Bank and Gaza, with current figures on the SCF loan portfolio.

Sebsted, Jennifer et al., Assessing the Impacts of Microenterprise Interventions: A Framework for Analysis, CDIE/USAID, March 1995.

Report presents a framework for evaluating the impact of microenterprise interventions using the household as the basic unit of measure. The advantage of household analysis particularly for microenterprises is the fungibility of capital and labor between household and enterprise uses.

International Investment and Development Company (SIDI), "Creation of a Palestinian Finance Company (PFC): Feasibility Study," 1994.

Feasibility study for the creation of a finance company to be developed in the Gaza Strip. Presents a good overview of the financial sector in WB/G. The analysis in this report is weak, however.

Silcox, Stephen C., "People-Level Impact Assessment of the Programs and Projects of USAID/Jordan in the Tourism Sector," USAID, April 1995.

This assessment detailed the various programs and activities assisting small and microenterprises in Jordan vis-a-vis the tourism sector. A visit was made to Jordan by the team leader to update his knowledge on a number of those programs which could possible serve to assist in the design of a proposed microfinance project for the WB/G.

Silcox, Stephen C., et. al., "Evaluation of the Private Enterprise Technical Resources Assistance Project (PETRA)," Louis Berger International, Inc./USAID, April 1992.

This was an evaluation of a project which was utilized to fund various private sector development initiatives by the USAID/Jordan Mission. This evaluation reviewed in detail the activities of the project in the support of small and microenterprises in Jordan, including various finance programs.

Smith, Timothy, "Small Business Support Project Survey Report, (Draft)" DAI/USAID, February 1996

This report provides a detailed description of the various services available to small businesses in the WB/G. It includes a chapter on financial services available to small businesses which was very helpful in locating the various sources of finance as well as presenting relevant information on the various programs.

Stallard, Janice K., Debjani Bagchi & Soha El Agouz, "Small and Micro Enterprise Development in Egypt: Opportunities for Outreach and Sustainability," National Cooperative Business Association and Environmental Quality International, May 1995.

Report evaluates the performance of the NCBA/EQI microenterprise credit project in Egypt. Identifies need for greater outreach, and proposes steps to move towards sustainability for the three Egyptian microenterprise credit projects - ABA, ESED and NBD/SECP.

Stearns, Katherine, "Egypt Small and Microenterprise Development Project: Mid-term Evaluation," GEMINI Technical Report Number 30, DAI/USAID, 1992.

Midterm Evaluation makes recommendations for improving outreach and financial sustainability of the Egypt microenterprise project. Recommendations are relevant for the design and evaluation of any microenterprise credit project, particularly in the Middle East.

United Nations Office of the Special Coordinator in the Occupied Territories, "Putting Peace to Work: Employment Generation," 1995.

Provides demographic breakdown on population of West Bank and Gaza Strip, discusses the effects of unemployment in contributing to social and economic instability, reviews the situation with Palestinians in the WB/G working in Israel. This report recommends that one part of Palestinian Employment Programme (PEP) should focus on the improvement of the small enterprise environment and providing the necessary support for increasing income from self-employment.

United Nations Office of the Special Coordinator in the Occupied Territories, "Putting Peace to Work: Private Sector," 1995.

Reviews various aspects of the private sector in the WB/G, including size of the sector, number and size of enterprises with breakdown by sector, employment, GDP, and import/export issues.

UNRWA, Monthly Report: Solidarity Programme, January 1996.

Internal UNRWA document summarizing Women's Solidarity Group lending program, including repayment rates, loan volumes, outreach and training figures.

United States Agency for International Development, "Policy Directive on Microenterprise Programs/Projects," USAID, 1994.

This policy directive provides guidance to USAID missions worldwide on the principles to be used when designing and implementing microenterprise development programs/projects. It devotes particular attention to the lessons learned in microfinance programs and was used extensively by the team in the suggested design of a microfinance project for the WB/G.

United States Government, "Commercial Guide for the West Bank and Gaza," U.S. Embassy - Tel Aviv and Consulate General - Jerusalem, July 1995.

This commercial guide presents a comprehensive look at the commercial environment of the WB/G through economic, political and market analyses. It provides general economic trends as well as specific information to assist U.S. exporters and investors in assessing the environment in the WB/G for investment and markets for various products.

Weidemann, Jean and Zohra Merabet, "Egyptian Women and Microenterprise: The Invisible Entrepreneurs," GEMINI Technical Report Number 34, DAI/USAID, 1992.

Report based on a baseline microenterprise survey of female entrepreneurship focuses on constraints to the growth and expansion of women owned enterprises and suggests interventions to alleviate those constraints.

World Bank, "Report of World Bank Mission on Small Business and Microenterprise Finance in the West Bank and Gaza," World Bank, February 1995.

This report provides an overview of the current situation in the WB/G regarding SMEs which reviews activities by NGOs in the sector and the problems of the present system. It then goes on to recommend the establishment of a Palestinian Enterprise Bank. Conversations with the Country Representative of the World Bank revealed that this recommendation will probably not be implemented.

ANNEX 6

DETAILED EXAMPLES

SUCCESSFUL MICROENTERPRISE FINANCE PROGRAMS IN OTHER COUNTRIES

The following detailed examples of successful microenterprise finance programs in other countries demonstrate the lessons learned in the field of microfinance which the team has attempted to bring to bear in the design of the proposed microfinance project for the WB/G.

THE ALEXANDRIA BUSINESS ASSOCIATION, EGYPT

BACKGROUND

The Alexandria Business Association (ABA) has its origin from the early 1980's. The ABA began principally as a group of private businessmen from Alexandria, Egypt, the second largest city and major seaport of the country. The ABA had been instrumental in giving a "voice" to the private sector by representing the sector to the government. USAID/Egypt was impressed by the focus and direction of the ABA, and entered into a formal relationship with the organization in 1989.

The ABA, as a whole, represents nearly 300 large business concerns. When the ABA began to focus on the small and microenterprise sector, about fifteen members took a lead position under the chairmanship of Mohammed Ragab. The executive board then selected Nabil El Shamy as the Executive Director for the Small and Micro Enterprise Project. Mr. El Shamy has remained as Executive Director since the inception of the program.

The ABA has developed a strong relationship with seven commercial banks in Alexandria. USAID, in the name of the ABA, makes a deposit with the local bank(s), on which the banks pay an interest fee. The total amount of the deposit then generates a credit line available at commercial rates of interest to the ABA to extend to its borrowers. Nearly all cash handling, including the loan release and installment payments, take place in the banks themselves, although the ABA runs its own management information system (MIS) and employs all its own loan officers and staff.

OPERATIONAL APPROACH

Since lending began in early 1990, ABA has taken a very measured approach in extending its services. There has been some public promotion of the program, but largely the information on the program has been spread by word-of-mouth. Alexandria is very densely populated, which allows for the spread of the program without much public promotion.

All loans are given on an individual basis, without utilizing groups. Although grouping of borrowers was considered in the preliminary phases of design, it rapidly emerged that Egyptian entrepreneurs were not willing to join into groups. On the other hand, Egyptians take a formal debt very seriously; as a consequence late repayment rarely goes above 2% of the outstanding portfolio.

The loan officer is the key decision maker in developing new clients. The loan officers (presently about 100 total) are assigned to a branch office; each branch office has a specific geographical area of Metropolitan Alexandria to cover. The loan officer develops the loan application in concert with the potential borrower, and appraises the business and the credit needs with the new client. The applications are then reviewed by the branch management; only exceptional cases are referred to senior management. The exceptional cases usually arise when the proposed loan size exceeds the norm significantly, or if some of the brief documentation required does not appear to be correct.

For new borrowers, and sometimes for repeat borrowers, the loan releases are made on scheduled days throughout the month. All new borrowers meet at their respective branch office of the ABA to receive their loan documents, as well as their loan release. Each member introduces her/himself, and reviews the loan documentation to make sure that it is in order. The new borrower also has the opportunity to hear, one more time, about his/her responsibilities and opportunities as a borrower from the ABA.

The operational approach to lending is partly innovative and partly follows the commercial bank's approach to lending. An approved borrower receives a cheque in the amount of her/his release, and signs post-dated checks in the amount of the installments that will come due over the course of the loan. As each repayment is made (at the respective bank office), the post-dated check is shown as being payment in full. In terms of recourse by the ABA, a late repayer has technically written a bad check, which could involve fines or imprisonment through the legal system. All borrowers who have repaid on-time and in-full are usually guaranteed subsequent finance, if they so desire, and qualify for a larger loan.

The management information system, operated by the ABA, is very tightly integrated into the operational approach of the ABA. All information on the borrower is maintained by the ABA, along with the status of the current and previous loans. At the end of each business day, the bank receiving the repayment sends a fax to the ABA. That report shows both payments that were made, as well as any that were missed. The information is put directly into the ABA's MIS, with a daily report then generated for the management and the loan officers. Any late payers are immediately followed up by the responsible loan officer, along with a letter of collection. If the repayment is still not made after one week, the loan is turned over to the Legal Department of the ABA for formal recourse.

LOAN PORTFOLIO

The ABA, since the inception of the lending program, has divided its portfolio between "micro" entrepreneurs, meaning five or less employees, and "small" entrepreneurs, meaning 6-15 employees. The planning target for the portfolio was to have at least 70% of the borrowers from the "micro" category, although no prejudice was held against the "small" entrepreneur. As the program has expanded, approximately 80% of the borrowers have come from the "micro" classification. During the design phase of the project, it was assumed that "micro" entrepreneurs would require loans of the equivalent of US$300-1,000, and that "small" entrepreneurs would require loans of the equivalent of US$1,500-4,000. Those average loan sizes have been adjusted somewhat based on market demand and usage.

The ABA program initially focussed on light manufacturing and processing operations, although more recently has begun to include the service and trade categories. From recent reports, the portfolio has been roughly, equally divided among the categories shown below.

- Garments, including woven and knitted clothing

- Leather, including the manufacture of shoes, handbags, belts, jackets, and other specialty items

- Wood, including full and partial fabrication of products like chairs, tables, beds, valances, mirrors, cabinets, and dressers

- Metalworking, which includes both manufacture and repair of a wide variety of aluminum, steel, and iron products

- A miscellaneous category that captures much of the large variety of products being produced by microentrepreneurs such as glass, lampshades, plastic products, spice grinding, and prepared foods.

The ABA has concentrated its service in the metropolitan Alexandria area, which has a population of nearly 4 million. For program purposes, the city is broken down in geographical sections for the location of the branches and assignment of the loan officers. The ABA is currently extending about 1,300 loans per month; on-time repayment is around 99%.

FINANCIAL PERFORMANCE

The ABA, although existing as an organization previously, essentially "started from scratch" with its lending in 1990. USAID deposits funds in the name of the ABA in several banks. The banks allow interest to accrue to the same account at an interest rate linked to the London Interbank Overnight Rate (LIBOR). The banks then make a line of credit available to the ABA for lending in an equivalent amount of Egyptian Pounds (L.E. or *Livre Egyptian*). The ABA makes loans from the credit line, and pays interest on the amount outstanding from the credit line; repayments by borrowers are placed back with the bank to reduce the outstanding amount of the credit line. This "collateral fund with right of offset" has worked very well; the original deposit in dollars maintains its value against a decline in the exchange value of the Egyptian Pound and serves as a guarantee against default. No default has yet occurred.

The ABA generally has about a 20% markup on its cost of capital; when the effective rate of its line of credit is about 17%, the ABA is charging about 37% effective to its borrowers. USAID did provide operating expenses to the ABA during its initial operation, but the ABA became self-financing (reached a break-even point) in almost exactly two years from the beginning of its credit operation. The program has continued to cover all of its costs, as well as expand, since early 1992.

STAFFING ISSUES

The Alexandria Businessmen's Association actually has a membership of about 300 business people from the city of Alexandria. For the purposes of the Small and Micro Enterprise Project, a four person "Executive Committee" was formed. The Executive Director of the project serves as a member of that Committee, which reviews day-to-day decisions. Larger policy questions are addressed by the entire ABA.

The staff of the ABA has grown dramatically along with the program; it now has nearly one hundred loan officers, as well as a legal department, a MIS department, accountants, a Deputy Executive Director, and branch managers. The loan officers come from a wide variety of backgrounds; some of the initial (and best) loan officers came from the Ministry of Social Affairs, some were small entrepreneurs themselves, while others had backgrounds in banking or finance.

Loan officer training is a continuing issue with the ABA, as they are continually expanding their program and have a continuing demand for new officers, above and beyond normal staff turnover. The training system, following successful recruitment, is essentially made up of one week of orientation to the program, two weeks of "pairing" with an existing loan officer, followed by one week of intensive familiarization with documentation requirements. When an existing loan officer has hit his/her upper limit on size of portfolio, the portfolio is divided so that a new loan officer starts out with some experienced borrowers, and the experienced loan officer will seek new replacement clients.

ABA relies heavily on an incentive system for its loan officers and staff, and has periodically revised its system as the program has grown. The incentive payments for loan officers are determined on a monthly basis by the number of loans disbursed and by the repayment rate of each loan officer. Loan officers must achieve a qualifying repayment rate of 97 percent to receive incentives, which are awarded according to the chart below. The ABA has utilized an incentive system for borrowers since the inception of the program, although the system has been modified a number of times based on experience. The description below is based on information presented to USAID West Bank/Gaza staff and the MSI Team during a visit to Alexandria in January 1996. The current system was initiated on January 1, 1996.

THE LOAN OFFICER INCENTIVE SYSTEM OF THE ABA

(Incentives Based on the Number of Accepted Loans)

Number of accepted loans within month per loan officer	Amount of Incentive (US$)
10-14	04.50
15-19	09.00
20-24	15.00
25-29	24.00
30-34	32.50
35 or more	45.00

NOTE: If the number of NEW loans exceeds 10 and up to 14, a bonus of US$.90 per new loan is added to the above incentive payments. This bonus is raised to US$1.50 for each NEW loan in excess of 14.

92

Incentives Based on Repayment Rates Achieved by the Loan Officer

Repayment Percentage	50-70 Active Borrowers	71-90 Active Borrowers	91-120 Active Borrowers	121-150 Active Borrowers	More than 150 Active Borrowers
97.0%	$21.00	$27.00	$36.00	$45.00	$52.00
97.5%	$25.00	$31.00	$40.00	$49.00	$56.00
98.0%	$30.00	$36.00	$45.00	$53.00	$62.00
98.5%	$36.00	$42.00	$50.00	$58.00	$68.00
99.0%	$42.00	$48.00	$56.00	$65.00	$74.00
99.5%	$51.00	$57.00	$67.00	$74.00	$83.00
100.0%	$65.00	$71.00	$82.00	$89.00	$100.00

Loan officers are generally recent university graduates, and begin with a starting salary of about US$45 per month, with yearly raises of 15 percent. Thus, even a US$9 incentive represents a 20 percent increase in monthly take-home pay. Approximately 70 percent of the loan officers earn an incentive each month, with three quarters of them earning more incentive than their monthly basic salary. Although the base salary of the loan officer is not as high as a loan officer might receive in the private sector, the loan officer earning incentives earns a salary that is highly competitive with the amount that s/he would earn working for local, publicly owned, financial institutions.

The branch managers, who each supervise 6 to 10 loan officers, receive an amount equivalent to 30 percent of the total amount earned by all of the loan officers. The operations manager, who supervises all of the branch managers, receives an amount equal to 35 percent of the amount received by the branch managers. Office support staff also receive incentives based on portfolio growth and performance. ABA also awards a prize of $75 to the extension officer of the month, $45 to the runner-up, and $30 to third place. Winners are selected based on their number of new loans, number of repeat loans, and repayment rate. There are also prizes for the three branch managers with the highest performing branches based on the same three criteria.

The office staff of the ABA also benefits from an incentive system, based on the workload of the office and the repayment rate. A matrix of the incentives for office staff is shown below.

ABA's INCENTIVES FOR OFFICE STAFF

# of loans processed	Percentage of basic salary	Repayment Rate (%)	Percentage of basic salary
800-1000	65	95	20
1001-1200	70	96	30
1201-1500	75	97	40
1501-1800	80	98	50
1801-2100	85	99-100	60
2101-2500	90		
More than 2501	95		

ABA management has been very pleased with the results of the incentive system, asserting that the benefits far outweigh the costs. ABA management feels that the incentive program has helped the institution meet its planned objectives in terms of number of borrowers, rates of repayment, and administrative efficiency.

94

KENYA RURAL ENTERPRISE PROGRAMME (K-REP)

(This description draws substantially from the report, "Small and Micro Enterprise Credit; Recommendations and Case Studies presented at the 'Best Practices' Workshop" by Jim Cotter, published by Labat-Anderson, Inc. in 1993, and on Karl Jensen's work in Kenya in 1995.)

BACKGROUND

The Kenya Rural Enterprise Programme (K-REP) was originally established in 1984 as an intermediary organization to provide training, technical assistance and financial management systems to local NGOs to improve their capability to design, manage, and implement small scale enterprise development programs. In recent years, K-REP has concentrated much more on direct provision of financial assistance.

In 1987, K-REP began to increasingly focus on minimalist credit. K-REP's objective was to get NGOs to abandon their social welfare mentality and adapt a business-like approach to achieving financial self-sufficiency. K-REP also stressed that these NGOs must end their long term dependency on donors. Donors should be seen as providing temporary capital to help NGOs build a sufficient financial base to become independent.

During its first phase, K-REP acted as an intermediary organization channeling USAID funds to NGOs lending to the informal sector. K-REP also functioned as an umbrella organization giving managerial and technical assistance to those NGOs to improve their capability to develop and manage credit programs.

Then K-REP began its own informal sector lending program, called the Juhudi Credit Scheme, which lent money through a group mechanism. K-REP developed its Juhudi Credit Scheme by applying lessons learned from both Kenyan and external loan program experiences. K-REP also supports and is rapidly expanding the Chikola Credit scheme, which works through rotating savings and credit associations (ROSCAs).

It is important to note that K-REP is an evolving organization. It has shifted its focus from broad-based assistance to other NGOs to more of a minimalist credit and savings institution. As lessons have been learned about credit operations world-wide, those lessons have been brought home to Kenya, sculpted to fit the local situation, and subsequent program growth has occurred.

OPERATIONAL APPROACH

K-REP targets new or existing informal sector businesses which don't have access to commercial credit and can respond effectively to its Juhudi Credit Scheme. It targets individually owned businesses which can profitably use a first loan of up to Ksh. 10,000 (about US$ 330), followed by incrementally increased loans. These businesses must be willing to participate in a group which processes loans and repayments, mobilizes savings and jointly secures the loans of group members.

K-REP also targets clients through its Area Credit Office (ACO) which is treated as a separate profit center and operates as a virtually independent entity. An ACO serves a radius of not more than 5 kilometers and is located in an area with informal sector enterprises large enough to generate 1,800 quality clients over the first year.

ACO credit officers promote the formation of self-selected membership groups which follow the basic criteria of the K-REP program. K-REP depends heavily on the performance of the group to analyze the issues below. Group members are responsible for verifying:

- Whether the person requesting a loan actually has a business;
- Whether the amount of the loan is reasonable;
- Whether the potential borrower is able to repay the loan;
- Whether the potential borrower will save as required;
- Whether s/he will cover the debt of members who default.

The credit officer trains group members to understand and perform these screening, monitoring and group loan guarantee responsibilities. K-REP stresses the need to carefully prepare these groups by improving their ability to appraise the size of loan needed and the borrower's repayment capability.

The loan application process is handled by groups of five members called Watanos which are comprised of business people who know each other. Six Watanos are grouped together to form a KIWA with 30 members living in the same area. Watano members are required to save 50 Ksh each for eight weeks before the first loans can be received.

During this initial period, training and orientation is given to the KIWA's by K-REP's credit officers at the weekly meetings during which savings are collected. These sessions cover group formation, responsibilities, program procedures and related matters. It is also during this period that the group members define and appraise each others loans. The Watano group members become each other guarantors.

K-REP disburses loans to one member of each Watano group after the first eight weeks, if savings and group training goals have been achieved. The disbursement is done through the KIWA at their weekly meeting. Following a second period of 4 to 8 weeks during which savings, loan repayment, and meeting attendance are monitored, more members of each Watano in the KIWA are eligible for loan disbursement until all are included.

Although the K-REP approach of working through a structure of small groups (Watanos) that are then formed into a larger groupings (KIWA) is uniquely suited to Kenya, the approach draws heavily from Bangladesh's Grameen Bank. K-REP has gained valuable experience from observing not only other NGOs in Kenya, but from world-wide experience as well.

The group approach to loans, extension and collection has been used extensively by K-REP; however, the loan officers themselves are now more deeply involved in loan appraisal.

PROGRAM MONITORING

K-REP has a well developed monitoring system which contains detailed baseline information from their clients. Information collection is repeated when a second loan is requested. The portfolio is monitored in monthly reports covering the status of the portfolio and an analysis of performance.

K-REP does periodic impact studies, as well as comparative analysis with the portfolios of the other NGOs doing similar lending of funds channelled through K-REP. This provides a rich opportunity to learn rapidly from both K-REP and the experiences of other organizations. K-REP documents and disseminates portfolio performance information to other credit providing NGOs within its network as a part of its role as an intermediary and technical support institution.

K-REP's PC-based system provides standard reports showing individual, group, and branch office performance in terms of loan repayment and savings records. These reports contain quantitative and qualitative loan repayment data, delinquency rates, recovery rates, loan eligibility ratings, portfolio at risk calculations, and other analytical percentages and ratios. The baseline and comparative data come mainly from the loan applications, intake forms, banking receipts, and credit officer transaction registers. The software programs developed by K-REP are now being used by other NGO credit programs in Kenya, including the PLAN credit program.

In addition to the standard monthly reports, K-REP produces periodic studies aimed primarily at assessing the program's impact. Currently the organization is in the third year of a three year impact study, using a control group of its Juhudi borrowers.

LOAN PORTFOLIO PERFORMANCE

K-REP has recently undergone an evaluation, and data from its Chikola loan portfolio appears quite promising. Reviewing the data from slightly less than 3,000 borrowers revealed that approximately 65% of the borrowers were female. 61% of the businesses were in manufacturing, 33% in commerce, and about 6% in services. Repayments under this program have been consistently around 99% on time, with only about 5% of the portfolio at risk.

FINANCIAL APPROACH

K-REP utilizes a number of approaches to help insure timely repayment by its borrowers. It uses the ACO branch budget as a management and planning tool to define the number and volume of loans necessary to achieve break-even; this serves as yardstick for determining the entire organization's costs and income.

K-REP has established a loan insurance fund to which all borrowers contribute one annual payment of 5% of the principal loan amount. This covers extraordinary losses due to death or disability.

K-REP also has a three-tier guarantee system to cover loan losses with savings. A loss is covered first from savings of the defaulting member, then equally from other Watano members, then equally from other KIWA member's savings. K-REP also maintains a reserve account with 1% of payments to cover bad debts.

For its own lending through the Juhudi program, the organization has been successful in raising donor funds and securing low cost financing from international development organizations. K-REP is providing a 70/30 mix of loans and grants to six other NGOs.

Under the Juhudi program, K-REP charges an interest rate of 27% per annum on reducing balances. They offer repayment terms of 13, 17, 26, 39, and 52 weeks. The interest rate reflects the attitude that the organization's credit programs must move toward sustainability. The spread on the money lent is a component of their revenue stream. K-REP also charges a loan origination fee of Ksh 100 and fees for technical assistance and other client services.

Watano and KIWA group leaders have the responsibility of collecting loan repayments and savings contributions at each week's meetings. They keep the records and pass on the money and receipts for money collected to the local Juhudi credit officers.

Members who have either four consecutive or four cumulative installments in arrears are considered to have defaulted. Loans are considered to be in arrears when borrowers are late with their payment for up to three weekly installments. Loan recall occurs in instances where KIWA members, who have failed to collect amounts on defaulted loans in full, are required to repay the total outstanding amount from their group savings.

In cases of default, the defaulting group member forfeits his/her portion of savings plus interest earned to the extent of the amount in default. If that is insufficient, the other Watano members, acting as secondary guarantors, forfeit their savings in equal proportion to cover the remaining unpaid balance. When some default amount remains, KIWA members act as final guarantors, forfeiting their savings in equal proportion to cover the remaining balances.

This combination of utilizing group methodologies and charging a reasonable, market-based rate of interest has served K-REP well. Arrears are manageable, and although K-REP showed a slight operating deficit for 1993, it appears to be well on the way to self-sufficiency. The Chikola operation was clearly in a profitable position at year-end 1993.

The Chikola is a traditional grouping of savers, based on the general concept of a "Rotating Savings and Credit Association" (ROSCA). ROSCAs are formal or informal groupings of people who pool their capital and make it available to an individual for a specified period of time. K-REP is rapidly expanding its financial linkage with the Chikolas. Because the organizational development of the individual Chikolas is already in place, K-REP is able to expand its program rapidly without high administrative costs.

STAFFING ISSUES

K-REP has a ten member board which includes representatives from the development, academic, political, and financial communities. Because of the financial and institutional objectives of K-REP, it requires Board involvement by leaders who can help guide the organization toward a market-oriented approach. In addition, the Board can help K-REP forge strong links with the banking community.

K-REP's Board of Directors plays an important role in providing vision and addressing strategic and policy issues. The Board is not involved in the day-to-day management or decision making process. This is the responsibility of the Managing Director, who is also a board member.

To minimize the effects of a self perpetuating board, appointment of board members are made by members of the Annual General

Meeting (AGM), which includes the two deputy managing directors and department heads. The appointment process insures that a good mix of skills and background is maintained. Board members and senior staff are involved in the identification process. In general, board members are expected to collectively bring knowledge and skills in the following areas:

- Organizational development and management
- Banking and finance
- Financial management, accounting and auditing
- Micro-enterprise development and micro-financial services
- Development economic and social studies, and,
- Public image and political protection

The staff of K-REP are highly motivated, but K-REP, like many evolving NGOs, has had difficulty in maintaining staff. Hence they have a continuing need to carry out staff training. K-REP's Training Department is run by a core staff of trainers who draw on experienced professionals from outside K-REP with a wide range of technical specialties. The department provides training in the following areas:

Credit Operations - This three-month course is a competency model designed to develop the knowledge, skills and attitudes necessary to implement group-based lending. The modular course uses a participatory, hands-on approach, alternating workshop theory and practice sessions with field training.

Credit Management - This course aims to develop conceptual and technical skills to design, implement and manage self-sustaining credit schemes. Participants are generally the persons responsible for designing and implementing credit schemes in their organization.

Loan Tracking - The course is designed to enable managers and accountants to automate credit operations and accurately interpret data.

Visitor Programme - A quarterly visitor programme is held which allows interested parties to tour K-REP and observe its operations first-hand.

INDONESIAN MICROFINANCE PROGRAMS

(The following description of microfinance programs in Indonesia is taken from Gemini Working Paper No. 20, "The Microenterprise Finance Institutions of Indonesian and Their Implications for Donors," by Elisabeth Rhyne, June 1991.)

Introduction

The provision of financial services to microenterprises in Indonesia is maturing into a complex and vibrant industry. Banks of several kinds are making a profit serving the enterprises of the poor, carving out market niches for themselves, and beginning to compete with each other for business. The profitability of the established institutions, the Badan Kredit Kecamatan in Central Java and its sister institutions in other provinces, and the Unit Desa system of the Bank Rakyat Indonesia, encourages new entrants into the industry. The central government is taking the first steps to regulate the industry as a full-fledged component of the financial system. Millions of customers are being served and more than a billion dollars have been lent. Few nations can boast that their microentrepreneurs are as well supplied with savings and credit.

Conditions and events in Indonesia have been particularly supportive of the development of microenterprise finance, but many of the same conditions can be found in other developing countries. It may be possible to build similar systems in many countries, if governments, donors, and local organizations work together. The development of the Indonesian system has been made possible by the combined and sustained effort of the Government of Indonesia and external donors (primarily the U.S., Agency for International Development and the World Bank).

Achievements

Two main systems provide savings and credit services to the smallest enterprises throughout Indonesia. The Bank Pembangunan Daerah (BPD) system consists of separate institutions operating in each of seven provinces and owned by provincial and district governments. The best-known of these (outside Indonesia) is the Badan Kredit Kecamatan (BKK) in Central Java. In each case, the provincial development bank, the BPD, supervises the system.

The second system is the Unit Desa System of the Bank Rakyat Indonesia (BRI). BRI is a large government-owned commercial bank, whose Unit Desas (village units) operate throughout the country. The BRI Unit Desa system may be more familiar to some readers as KUPEDES, the loan program offered by the Unit Desas.

VOLUME OF ACTIVITY IN BPD AND BRI SYSTEMS, DECEMBER 1989

	BPD System					
Activity	West Java	Central Java	East Java	Bali	**All BPD ***	**BRI Unit Desa**
Lending:						
Loans Outstanding (millions of US$)	$13.6	$12.7	$1.9	$2.8	$33.3	$614.5
Number of Loans	123,000	510,000	114,000	39,000	829,000	1,800,000
Average Amount Outstanding	$202	$25	$17	$72	$40	$437
Savings:						
Total Savings (millions of US$)	$12.2	$2.6	$0.5	$2.3	$18.4	$646.8
Number of Savers	288,000	501,000	140,000	69,000	1,050,000	6,700,000
Average Savings	$69	$5	$4	$34	$18	$97

* Data for all BPD includes three provinces in addition to those shown: West Sumatra, South Kalimantan, and Nusa Tenggara Barat.

Each of the BPD institutions has a slightly different structure, and each has been operating for a different amount of time. This makes direct comparison across provinces inappropriate. The BPD systems are currently serving 800,000 borrowers, and the BRI Unit Desa system reaches 1.8 million customers. A total of $647 million in loans are outstanding. Even at this impressive level, the systems have not yet reached their full potential, as the rapid growth in some of the systems shows. The recently revitalized BPD system in East Java and the relatively new system in Bali have posted growth rates of more than 100 percent per year. Even the BRI system, now six years old, continues to grow at 35-40 percent per year.

Loan sizes are small, indicating that the programs are reaching genuinely poor customers. The BPD systems, which operate posts in villages, provide significantly smaller loans. Thus, they tend to serve lower-income customers, those whose activities are restricted to the villages.

The systems that have made voluntary savings a priority, namely BRI, West Java, and Bali, can boast savings that fully or almost fully support lending activities. They are demonstrating that lending to the poor can be based on the savings of the same communities. In fact, more people are interested in saving, given a convenient, safe mechanism, than in borrowing.

The profitability and general financial health of these systems are as impressive as their reach. When judged by commercial banking criteria, these systems perform well, as shown in the next table, although their structures are somewhat unorthodox.

FINANCIAL PERFORMANCE OF BPD AND BRI SYSTEMS, DECEMBER 1989

Indicator	Central Java	East Java	Bali	BRI Unit Desa
Profitability: Return on average assets	6.3%	30.0%	15.2%	3.6%
Liquidity: Loans/Total assets	84.6%	96.1%	82.5%	76.9% *
Asset quality: Past due loans/gross loans	19.7%	8.5%	n/a	5.4%
Capital adequacy: Equity/Loans outstanding	37%	43%	15%	n/a **
Growth rate: Loans	12%	140%	119%	57%
Growth rate: Savings	26%	406% ***	144%	95%

* For BRI, the liquidity measure used is loans/(deposits plus borrowings).
** As a program of a larger bank, the BRI Unit Desa system does not have its own equity capital.
*** Pilot program initiated in 1989.

All these systems generate strong profits and are growing rapidly, especially in savings, in line with the adoption and use of improved savings vehicles. The BRI system is financially the strongest, with what is judged to be excellent profitability by international standards, good liquidity, and good asset quality. The financial picture for the BPD systems looks quite different, largely because these institutions are highly capitalized. A major portion of the funds used for lending is equity from original donor or government capitalization and from retained earnings. Because they pay no interest on equity, their cost of capital is low, and profitability high. The system in Bali, because it depends more on savings than do the other two BPD systems, has a higher cost of capital and lower profits.

A serious arrears problem in Central Java reduces interest income, and hence profits as a percentage of assets. The current arrears problem is not as severe as it appears from these figure, however, because the BKK has only just started writing off bad loans, some of which have accumulated over a 19-year period. Arrears management is one of the most important problems facing the BPD systems at this time, but they have not had to address that problem because their strong equity position shields them.

Although these systems are not free of problems and risks, they have achieved very impressive results. These results are derived from:

- A proven credit delivery methodology;
- The introduction of voluntary savings instruments;
- The individual lending and deposit-taking units, which are the cornerstone of financial self-sufficiency;
- The supervisory structure, which enforces and enables good management by the units; and
- Supportive policy and government.

104

BANCOSOL

(Much of the following information on BancoSol was taken from a chapter in The New World of Microenterprise Finance - Building Financial Institutions by Maria Otero and Elisabeth Rhyne, Kumarian Press, 1994, entitled "The Creation of BancoSol in Bolivia" by Amy Glosser.)

Banco Solidario, S.A., or better known as BancoSol, began operations in 1992 as the first private commercial bank in the world specifically targeting microenterprises. Today BancoSol stands out as one of a handful of sustainable microenterprise financial services.

BancoSol began as an Bolivian NGO called PRODEM which was organized with the support of ACCION, a U.S.-based NGO, under the direction of influential Bolivian businessmen. PRODEM's credit program uses the solidarity group lending methodology. Short term loans with an average size of US$273, provide working capital to over 13,300 borrowers for a total of US$27 million. The repayment rate has traditionally approached 100%. PRODEM credit agents are responsible for up to 350 clients and an average portfolio of US$70,000.

In spite of considerable success in its lending portfolio PRODEM was constrained by legal restrictions which made it impossible for PRODEM to offer a fuller range of financial services especially savings. PRODEM was further constrained by banking regulations which proscribed mobilizing additional sources of capital from client savings, commercial debt, or investor equity. These limitations made it impossible for PRODEM to achieve institutional sustainability and the capacity to scale up to meet market demand.

The directors sought an alternative to the NGO model and ultimately decided upon the creation of a commercial bank. The new banks was able to sell shares, and borrow at competitive market rates. PRODEM continued to assume training functions and other costs not easily absorbed by loan costs.

BancoSol officially opened its doors in February of 1992. When it opened, it only offered two services: solidarity group loans, and compulsory savings. Since then BancSol has also added voluntary passbook savings. BancoSol has a policy of locating its branch offices in or near major markets, modestly designed to avoid intimidating clients, and holding costs to a minimum.

BancoSol pays clients 20.4% for savings, which is slightly lower than market rates. Loans are granted at an effective rate of 55-57 percent which is roughly double the commercial bank rate. The average loan size of BancoSol's portfolio as of 1993 was under US$300, compared to commercial bank loans ranging from US$35,000 to 130,000. Seventy percent of BancoSol's clients are women. The repayment rate is 99% within one week of loan due dates.

The critical question facing BancoSol today is whether it can achieve profitability. BancoSol has made the transition from NGO to commercial bank, while successfully mobilizing savings and quickly expanding its portfolio without compromising repayment rates.

It is not yet clear whether BancoSol can achieve profitability while maintaining its commitment to microenterprises. Because small loans are more costly to make, BancoSol has begun making loans to larger enterprises. While the majority of BancoSol's loans are to microenterprises, a growing share of its outstanding portfolio consists of a smaller number of larger loans. This dilemma is well stated by Amy Glosser in her description of BancoSol, "BancoSol leadership has strongly stated its commitment to keeping the microentrepreneur the focus of the bank. This commitment is sure to be tested again and again."

ADEMI

(Most of the following information came from ADEMI's 1994 Annual Report.)

Associación para el Desarollo de la Microempresa, Inc.(ADEMI) in the Dominican Republic is one of the most successful microenterprise lending institutions in the world.

ADEMI is a private, limited liability corporation created in 1983. ADEMI was organized under the guidance of a consortia of Dominican NGOs, the Banco Popular Dominicano, and prominent government officials. Initial funding came from the European Investment Bank, USAID, GTZ and Agricultural Cooperative Development International (ACDI), a U.S. NGO.

ADEMI began in 1983 in the low income barrios of Santa Domingo, the capital. The initial objective was to generate new employment and reduce underemployment by financing small and microenterprises operating in urban areas. ADEMI expanded by making its methodology available to existing NGOs throughout the Dominican Republic.

As of December 1994, ADEMI had 24 offices throughout the country. In 11 years ADEMI has financed 28,855 small and microenterprises and is no longer dependent on donor funds, though it still borrows at concessionary interest rates. In 1991, of 11,249 loans made, 82 percent were less than US$800, and 60 percent were under US$400. In 1994 alone, 13,184 loans were made for a total value of Dominican Pesos (RD$) 295.3 million realizing a net profit of RD$22,376. Based on a KPMG audit, ADEMI's eleven year Internal Rate of Return is 14%. Return on equity is 17%. Since 1983, ADEMI's portfolio has expanded by 40% per year in US dollar terms. ADEMI has financed almost 4,000 new enterprises and supported the creation of over 22,000 new jobs.

ADEMI has had considerable success at mobilizing savings and thereby reducing its dependence on donor capital. In 1994, there were 88,607 depositors with a total of RD$914 million in deposits.

ADEMI has 179 employees, 98 of whom work as credit agents. ADEMI conducts more training than most microenterprise credit institutions. In 1994, ADEMI conducted 50 seminars and training sessions in accounting, marketing, management, and costs of production. Training costs are supported by fees and donor subsidies and are not included in the cost of funds lent.

ADEMI uses a "do what works" approach to its credit methodology. Most loans are character based to individuals, although larger loans may require guarantors and collateral when appropriate. ADEMI borrowers receive small short-term loans with frequent and regular payments. Upon timely repayment, borrowers can access successively larger and longer-term loans to meet their businesses expanding needs.

ADEMI's strength can be attributed to a strong and committed Board of Directors made up of business people rather than donor agents, skilled administrative and operational staff, a low level of subsidies, and a high capacity to mobilize savings. In wrestling with the paradox of running a financial institution and helping the poor, professionalism and financial sustainability comes first.

ANNEX 7

BREAKEVEN ANALYSIS MODEL

FOR THE OPERATION OF A MICROENTERPRISE FINANCE FACILITY

* Notes to the Financial Analyses in the Breakeven Model

1. The table assumes loan average length of six months.

2. The Salary and Incentives line should be a total of salaries, incentives, and operational costs incurred.

3. The Overheads line is for any additional costs above those in Salaries and Incentives.

4. The Average Loan Size is purely an estimate but is based on slow but steady growth from a small base.

5. The Interest Rate Mark-Up indicates that irrespective of the cost of funds, this mark-up would generate the income line. If the cost of funds is 20%, and the Interest Rate Mark Up is 20%, then the real gross income for the unit would still be 20%, although the end-use effective interest rate to the borrower would be 40% per annum effective.

6. Average Loans Outstanding is the total number of individual loans outstanding under the project.

7. Total Loans Outstanding is an amount, not denoting number of borrowers, but rather outstanding capital.

8. Default is an average annual percentage.

9. Interest Income is based on the variable utilized, and includes the cost of funds.

10. Principal Required is additional capital required to support loan growth.

11. Gross Interest Income is as stated.

12. Provision for Bad Debt is calculated (and linked) by the Default variable.

13. Net Interest Income is Gross minus Bad Debt Provision.

14. Cost is a sum of Fixed Costs

15. Profit/Loss is the difference between Net Interest Income and Cost

Financial Analysis

Profit & Loss Scenario 1 — 2 Year Model

MicroEnterprise Lending Unit — 6 Month Loan Avg.

(This Can Be in Any Currency)

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 5	Qtr 6	Qtr 7	Qtr 8
FIXED COSTS								
Salary & Incentives	5,000	5,000	5,000	5,000	10,000	10,000	10,000	10,000
Overheads	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500
VARIABLES								
Avg. Loan Size	1,000	1,200	1,400	1,600	1,800	2,000	2,200	2,400
Interest Rate Mark-Up	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%
Avg. Loans Outstanding	20	40	60	80	100	120	140	160
Total Outstanding	20,000	48,000	84,000	128,000	180,000	240,000	308,000	384,000
Default	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Interest Income	1,000	2,400	4,200	6,400	9,000	12,000	15,400	19,200
Principal Required	20,000	38,150	60,360	86,630	116,960	151,350	189,800	232,310
Gross Interest Income	1,000	2,400	4,200	6,400	9,000	12,000	15,400	19,200
Provision for Bad Debt	150	360	630	960	1,350	1,800	2,310	2,880
Net Interest Income	850	2,040	3,570	5,440	7,650	10,200	13,090	16,320
Cost	7,500	7,500	7,500	7,500	12,500	12,500	12,500	12,500
Profit/Loss	(6,650)	(5,460)	(3,930)	(2,060)	(4,850)	(2,300)	590	3,820

ANNEX 8

NOTES ON MEETINGS WITH BANKS

IN THE WEST BANK AND GAZA

The following is a series of brief notes based on meetings with banks currently operating in the West Bank and Gaza. This is not intended to be a description of the banks, but rather significant highlights from those meetings. Conclusions are included in the main text of the report. Notes made in parentheses were written by the author at the end of the mission when further information had been gathered.

10 January, Commercial Bank of Palestine, Ramallah, West Bank

Met with Khaled M. Ghabeish, General Manager of the Commercial Bank of Palestine.

- This was the first Palestinian Bank formed in the West Bank since 1967, with the current formation being established in 1994.

- Mr. Ghabeish recognized the importance of light manufacturing and handicraft production in the Ramallah area.

- The CBP has 60-70% of its deposits in circulation as loans (as opposed to the overall figure for the banking sector in WB/G of 20%). He felt that the personal approach to depositors and borrowers was of key importance.

- When questioned about the use of donor funds, he felt the first use should be to subsidize the interest rate being charged to the borrowers. (This is important in that it was echoed by other bankers in later interviews.)

- The CBP has also just opened a second branch in Gaza City December 31, 1995.

10 January, Arab Bank, Ramallah, West Bank

Met with Shukry Bishara, Executive Vice-President and Regional Manager, and Joseph J. Nesnas, Head of Project Finance and Institutional Accounts Coordinator.

- Arab Bank has $20 billion in assets, largest bank in the WB/G area by a factor of 10. The Arab Bank system has attracted $.5 billion in deposits over the last 6 months (which would represent about one-half of the total deposits with banks in WB/G). Arab Bank has opened 12 branches in 14 months in the WB/G (subsequent interviews pointed out that many of these openings were in fact reopening of branches that were closed

110

during the Israeli occupation).

- The bankers pointed out that there were many problems in the area, and could be classified as legal, financial, geopolitical, and policy.

- Mr. Bishara noted that "..banking now...is a borrowers market." (This should be true, based on the 5:1 deposit/loan ratio.) The bankers further pointed out that, "The environment will have to change...for the banks to engineer new products." (This was borne out later in that the Palestinian Monetary Authority has not yet issued any guidance on reinvestment.)

- Arab Bank is also handling "Home Improvement Loans", a loan program being carried out by the Cooperative Housing Foundation on behalf of USAID. The lending started in October, with 150 loans extended averaging about $6,000 each. The loans are extended at 9% per annum, and USAID takes 90% of the risk in case of default.

14 January, Bank of Jordan, Nablus, West Bank

Met with Salah F. Masri, Manager, Bank of Jordan.

- Bank of Jordan is handling payrolls and loans to Palestinian National Authority and United Nations employees, and has been open since mid-1994. The Bank of Jordan accepts employment with these entities as sufficient guarantee on loans of 1-3 years, with most of these small loans ($3,000-6,000) being used by men for marriage expenses.

- There are eight other banks in Nablus. Bank of Jordan charges 10% interest per annum; and it was thought that money changers were getting about 6% per month. Bank of Jordan does mostly "name lending" (explained in main text of report). Bank of Jordan currently has about 47,000 depositors, mostly with "small" savers.

- Mr. Masri sees strong possibility of growth in WB/G, but is actively seeking corporate, rather than small, borrowers. The Bank of Jordan is currently handling accounts for Save the Children Federation, and is running a lottery on savings accounts to entice more depositors.

16 January, Bank of Palestine, Gaza City, Gaza

Met with Khaled H. Shawa, Assistant General Manager, and Ihsan Kamal Shaushaa, Foreign Relations Manager.

- The Bank of Palestine opened in 1960 but was closed after the 1967 war. It reopened in 1981, but as an agent for Israeli banks through only one branch. Bank of Palestine now has 7 branches in the Gaza Strip and 3 branches in the West Bank, with $10 million in capital.

- The Bank of Palestine gives loans mostly for less than two years, and provides overdraft facilities for merchants.

- Mr. Shawa points out several of the difficulties that small businesses have in exporting even to the West Bank or even to get to the West Bank during the Israeli-enforced closures.

- The bank will take three cosigners as collateral on smaller loans, but prefers mortgages on loans of over $50,000. Machines and cars do not make good collateral instruments. (This was later re-enforced several times; the machines do not have any formal registration or valuation and there is a high preponderance of cars originating in Israel that are now held in Gaza.)

- The bankers pointed out that they had done some lending to local building contractors, but most contractors were building for the Palestinian Authority (PA), and when the PA is slow to pay for work completed, the contractors cannot make timely repayment to the bank. The bankers pointed out that only about 4% of their borrowers would be considered problematical, and stated that the court system is "good, but slow". As a consequence, Bank of Palestine always tries to make a direct settlement with the borrower who is late or in default.

- Bank of Palestine takes $300 equivalent as a minimum deposit; it pays 4.5-5% on US$, 6% on JD, and 11% on NIS. Bank of Palestine has made some loans to start-up businesses such as carpentry, welding, and clothing manufacture, but still requires a feasibility study (which is generally produced by a local CPA). However, the bank still requires collateral.

- The Washington-based Loan Portfolio Guarantee Program had contacted the bank, but the bank is still requiring 100% collateral even with the LPG. (This was borne out by all the other banks interviewed.)

17 January, Cairo Amman Bank, Gaza City, Gaza

Met with Ziyad N. Abushaban, Manager for Gaza Branches, and Ghalib A. Hantoly, Regional Credit Facilities.

- Cairo Amman is providing some salary-based lending for consumer loans. Most of these loans are in the $3,000-4,000 range, and for a maximum of 30-36 months. Their other lending is for commercial, agriculture, housing, and industries.

- Urban land in Gaza City is selling for $1,000/sq. meter. (This was borne out in other interviews, where many returning Palestinians are looking first to invest in real estate.)

- Cairo Amman has three branches in West Bank and two in Gaza. While they have plans to expand further, the Palestinian Monetary Authority is making noises about slowing the growth of the banking branches.

- Cairo Amman is currently audited by Central Bank of Jordan. The PMA is asking for a reserve requirement of 10% of US$, 14% of JD, and 14% of NIS. There is no Palestinian currency because there is no Palestinian state. (Given the free exchange of currencies, this is probably not much of an issue beyond a political one at this point.)

- One of the common forms of collateral accepted is the "tabu", which is a clearly stated cadastral survey. The problem is that these surveys, in many cases are not complete.

17 January, Arab Bank, Remal Branch, Gaza City, Gaza

Met with Azan Shawaa, Branch Coordinator for Gaza and the West Bank

- Arab Bank is currently providing banking facilities to CHF, ANERA, as well as some IFAD funded projects. It is intending to provide further services to IFAD when they soon open their fisheries loan project.

- Arab Bank is providing loans to Palestinian National Authority soldiers. It will make two year loans for an amount that equals ten times the monthly salary of a soldier. It uses the pension fund of the soldiers as a guarantee. It felt that nearly all of the loans were being used to purchase household goods.

- The bank is also providing loans to returnees to purchase cars. The current rules state that a returning Palestinian can purchase one car upon return without paying the standard 200% tax. (The same formula is being used in Israel for new immigrants.)

- Arab Bank is handling PA salaries, and is willing to make loans to PA employees where it can make salary deductions immediately. The PA has only been late a couple of times with its deposits to cover salaries.

29 January, Cairo Amman Bank, Ramallah, West Bank

Met with Yousef S. Bazian, Regional Manager for West Bank and Gaza, and George Dallal, Senior Assistant General Manager (based in Amman).

113

- The meeting focussed mainly on usage of the Loan Portfolio Guarantee Program. The bankers felt the LPG was problematical because of its heavy emphasis on new businesses (which are inherently riskier). They currently have $661,000 out to 26 customers; with the exception of four larger borrowers, most of the loans made under LPG are in the $10,000-20,000 range.

- The bankers felt that the only way they would be interested in lending to microenterprises would be if the donor agency would be willing to take 90-100% of the risk involved, or for the donor to merely give them a grant to carry out the lending.

29 January, Jordan National Bank, Ramallah, West Bank

Met with Malek W. Khadder, Manager, Jordan National Bank.

- Jordan National Bank is newly re-established in the area, and has also recently joined the LPG. Nablus and Hebron branches are more or less equal with the loans they have extended thus far under the LPG, with a total of $638,000 extended in credit thus far. Most of the loans they have extended are in the $5,000-10,000 range, and are for 1-3 years. Most are start-up, family-owned enterprises. The loans are more or less equally divided among credit lines, fixed term, and letters of credit. The customer does not know about the LPG. (This was reflected in all interviews regarding the LPG.)

- While the bank is interested in further lending under the LPG, it is still seeking the (phantom) corporate borrowers.

- Jordan National Bank has about $7,000,000 in deposits through its three branches in Hebron, Nablus, and Ramallah.

ANNEX 9

SMALL AND MICROENTERPRISE FINANCE:

PROGRAMS AND SOURCES IN THE WEST BANK AND GAZA

OVERVIEW

This section describes and summarizes in detail various NGO and other financial services available for small and microenterprises in the West Bank and Gaza. No commercial banks directly lend to microenterprises, though several are working with one or more NGOs to extend loans to small businesses. Three Palestinian NGOs have been lending to microenterprises since or before the Intifada period, but with little success. The failure of the early microlending programs is due to lending technologies not adapted to microenterprises, a more hostile enabling environment, and a relief rather than a development philosophy of the program managers. The informal sector continues to be the major source of finance for the poor and microenterprise operators.

As credit-granting NGOs change their mission from relief to economic development under an improved civil administration, loan recovery rates are improving. All of the NGOs currently serving microenterprises have adopted improved and cost efficient technologies for lending, reducing or eliminating the need for collateral, using solidarity groups and other forms of moral security, and character based lending.

All of the microlending programs visited are too new to realistically assess. UNRWA and SCF and CARE include reaching operational self-sufficiency as one of their targets for the next two to five three years. None of the NGOs visited is close to covering their operating costs, given the size of their loan portfolio and the interest rates being charged. Under optimal conditions, SCF and UNRWA could cover all of their operating costs in the next few years, assuming significant portfolio growth.

Several NGOs visited are charging positive real rates of interest (36%-44% effective). At these rates, it will take three to five years before interest rates will cover both operating costs and the cost of funds. All of the loan programs visited base their interest rates on what they perceive the market will tolerate and not on what it costs to deliver loans or what those costs are expected to be as their programs reach scale.

NGO linkages to commercial sources of funds, an essential step to institutional sustainability, is either lacking or nascent. Most of the programs visited, encourage or require that their clients maintain savings in a commercial bank, and SCF and ANERA use commercial banks as a transactions window for a small fee. None of the NGOs contacted anticipate liaising either as an on-line lender or a broker of commercial bank funds in the near future. The strongly held, and not completely incorrect, view is that the commercial banking sector is not interested in supporting a microenterprise lending portfolio, and that microenterprise programs could not afford to lend microenterprises at current rates if they had to pay commercial rates for their funds.

DESCRIPTION OF NGO MICROENTERPRISE FINANCE PROGRAMS

There are a number of NGOs currently providing financial services to micro and small scale enterprises in the WB/G. Two, UNRWA and SCF, are playing a prominent and expanding role in microenterprise lending. ANERA has a relatively long history of lending in the WB/G, but is new in the microenterprise field. CARE has just begun a pilot program that incorporates tested microfinance techniques.

ANERA operates three micro, small, and agricultural enterprise loans. The most recent of these makes loans to women, through existing indigenous NGOs.

Two indigenous NGOs, the Economic Development Group (EDG) and the Arab Development and Credit Company(ADCC) have decided to move away from their microenterprise lending activities, and are now reaching out to serve small and medium enterprises. Eighty percent of the EDG's current portfolio consists of loans under US$10,000. Both the EDG and the ADCC will continue to make loans to larger microenterprises with a minimum loan size of US$10,000.

The YMCA is assisting new business start-ups for graduates of their vocational training courses, providing access to equipment on a kind of lease basis.

The following provides a more detailed description of the NGOs now providing some level of small and microfinance in the West Bank and/or Gaza.

United Nations Refugee and Works Agency (UNRWA)

UNRWA is currently operating three small and microenterprise lending programs: The Small Scale Enterprise Fund, the Microenterprise Credit Project, and the Women's Solidarity Group Lending Program. While all three of these programs are too new to evaluate, UNRWA has recognized the importance of moving towards operational self-sufficiency. Only two of the three programs, the Solidarity Group Lending Program, and the Microenterprise Lending Program, target microenterprises. The Microenterprise Lending Program has just opened, targets male enterprise operators, and will make individual loans up to US$8,000).

116

Solidarity Group Lending Program

This program lends exclusively to women, predominately for market and retail trade activities, in the refugee camps and low income neighborhoods outside of the camps throughout the Gaza Strip.

Loans are made to individual members of solidarity groups consisting of 4-8 women. The groups guarantee each member's loan. Interest is 2.2% per month simple (41.5% effective). Group members are able to access loans that begin at NIS2,000 for four months for first time borrowers. Assuming timely repayment, group members can borrow up to 4,000 NIS for nine months in the third and following loan cycles. Borrowers are required to participate in short financial management training sessions as they move up to higher loan amounts in successive loan cycles. The program encourages savings among its clients, but does not require savings.

UNRWA has five women credit agents who will be expected to support a portfolio of 120 borrowers each in the next year. In the next three years UNRWA believes it can become operationally self-sufficient and assumes a portfolio size of 5,000-8,000 borrowers.

Microenterprise Credit Program

This is a new individual lending program that targets, but is not limited to, male microenterprise operators. Interest rate on loans will be 2.2% per month, the same as with the Solidarity Group Program. Loan ceilings will be set US$8,000. The UNRWA Microenterprise Credit Program will rely on two personal guarantors, one of whom must be gainfully employed with a firm willing to garnish the guarantors' wages in case of borrower default. Both guarantors must have accounts in a commercial bank. These funds are blocked in case of borrower default. Only one loan has been released to date so it is too early to analyze this program.

Small Scale Enterprise Program

This program focuses on small scale and medium enterprises in the Gaza Strip. Average loan size is about $25,000. Loans must be guaranteed by at least one UNRWA employee whose wages are garnished in case of borrower default.

One of UNRWA's main strengths to date may eventually become a constraint. UNRWA has operated in Gaza since 1948 and has widespread respect and support. It is also the largest employer in the WB/G. These factors strengthen loyalty and support for UNRWA programs. UNRWA seems to have had little difficulty in making the transition from a relief mentality to a financial institutional development one. However, as a large bureaucracy, UNRWA may have difficulty splitting off successful programs from its portfolio of activities. UNRWA has a high administrative cost structure and it has no plans to access commercial sources of funds.

Save the Children Foundation (SCF)

SCF is a notable exception among the various NGOs providing financial services in the WB/G since it has made the decision to reach down to ensure credit access by the most underserved population in the WB/G -- poor refugee women.

In 1986, SCF began financing small scale projects with an average loan size of US$4,000. Based on an evaluation conducted in 1992, SCF decided to abandon its small scale enterprise portfolio for a microenterprise program that reaches the "poorest borrowers". In June 1995, SCF started the solidarity group lending program for women borrowers.

The Women's Solidarity Group Lending Program was capitalized from funds remaining from the its Small Enterprise Development (SED) program (approximately one million dollars). Of the original funds, roughly $750,000 remains. SCF continues to collect on defaulted loans from its earlier SED program with a better than 25% recovery rate. Funding for the SCF program now comes principally from the British ODA, with smaller amounts from the Dutch government and private contributions.

The first loan under the new Women's Solidarity Group Lending Program was made in June 1995. Since then 525 loans have been made to 497 borrowers. Loan disbursements as of January 15, 1996 have totaled US$233000, with an average loan size of $444.

The SCF program makes individual loans to women in groups whose average size is 13 members. While the group's size is fairly large, the small loan size necessitates larger groups to minimize operating costs. Loans are of fixed amounts per loan cycle with JD200 granted the first cycle, JD250, the second cycle and JD350 the third cycle. After the third cycle. members can continue to borrow, but loans are capped at JD 350 As soon as a loan is repaid, the borrower can access an additional loan with immediate approval.

The interest rate on loans is set as 11% of principal lent over six months. Disbursed in Jordanian Dinars, the loans are pegged to the dollar. The effective rate is 44.15% (see Annex 11 for calculation).

It is too early to assess the SCF program against any realistic measures of microenterprise credit outreach, efficiency or sustainability. Like the UNRWA and pilot CARE program the program is charging positive real rates of interest. SCF should be able to cover all lending costs in four years, if growth projections are realized and costs are contained.

In addition, the SCF program has a mandatory savings program. Borrowers are required to open a group account in a commercial bank. These funds are not blocked but would be seized in case the group failed to repay its members debt. Forced savings programs are often criticized because borrowers perceive the forced savings as a cost of obtaining a loan rather than as a savings instrument. This does not appear to be the case with the SCF program. Program participants are saving much more than the minimum required. Member savings now total over one-third of borrowed funds.

Although the program is too early to evaluate, initial repayment rates are very high. SCF has adopted a low cost delivery system and expects to achieve full cost recovery, excluding the opportunity cost of funds, within the next five years.

SCF management has adopted a strategy for program institutionalization in which SCF expects to sell its methodology to interested NGOs. SCF would provide training, technical support, a functioning MIS system, and start-up capital to NGOs interested in adopting a microenterprise lending program. This strategy has not yet been implemented to date.

CARE International

CARE recently returned to the West Bank and Gaza since pulling out during the Intifada; CARE had been working in the West Bank and Gaza since just after the Six Day War. CARE has begun a pilot microenterprise finance project using the village banking methodology. This pilot activity is financed from CARE's own funds, appears well designed, recognizes the importance of achieving sustainability, and is looking to capitalize with donor funds and an increasing share of participant savings.

The CARE model provides matching capital to each group based on a minimum savings of 10 NIS per member per week. The average group size is 20 members. After thirteen weeks CARE matches the groups savings 1:1 with a contribution of NIS2,600. With a capital base of NIS5,200, the group begins lending to its members at an interest rate of 2% per month. Members are assured access to additional and progressively larger loans if they repay on time. Penalties for late payment are imposed.

Initial loans are for three hundred dollars, second loans for $500. The pilot activity is still in its first round for all groups. CARE recognizes that its clients are unlikely ever to be able to access loans directly from a commercial bank and therefore envisages a second phase of individual loans up to US$5,000 for group members who successfully repay their solidarity group loans. In addition to the mandatory savings, members can contribute additional savings to the group. Assuming high recovery rates, members will receive "dividends" on their savings.

CARE International continues to strengthen its experience in the field of microenterprise lending with a respectable degree of cost recoverability among it programs worldwide. The growing institutional memory that CARE International is developing increases the probability of success of its individual country-level microfinance programs. The principal weakness of the current CARE program in the WB/G is that it has no links to the banking sector nor any apex financing facility that would lead to expansion and sustainability.

American Near East Refugee Aid (ANERA)

ANERA has five years experience in the operation and management of several rural and urban small and microenterprise lending programs. ANERA has worked with a diverse set of mechanisms delivering small loans. ANERA also works with a number of credit and multi-purpose cooperatives begun during the Jordanian control of the West Bank.

1. **Small agricultural loans through regional marketing cooperatives** in the West Bank and Gaza. This program is funded under the USAID Development Assistance IV project which dispersed US$1.5 million through 7 regional cooperatives, five in the West Bank and two in the Gaza Strip.

These village cooperatives act as village banks serving the farmer members in their respective districts. The program is ongoing with each cooperative managing its own revolving loan fund. To date 610 loans have been dispersed with a maximum loan size of US$5,000 at 8% for 2-3 years. Personal and physical guarantees are required. Interest and repayment of principal are pegged to the dollar in order to protect the capital base of the revolving fund.

2. **A 100% loan guarantee scheme with the Cairo Amman Bank** (CAB) was also funded by USAID in 1990 during the Intifada to encourage the CAB to lend to small and medium sized firms. AID's guarantee was funded at $100000. The maximum loan size was $25,000 at 9% plus an initial service fee. Funds were pegged to the Jordanian Dinar. Loan terms were for up to three years and guarantees were required.

Only four loans were granted under this program. The guarantee scheme was abandoned in favor of a new USAID centrally-funded Loan Portfolio Guarantee scheme. Bank response to the new guarantee scheme appears modest at best because lengthy and complicated reporting requirements raise the already high transaction costs of making small business loans.

3. **Small agricultural loans funded by IFAD through the Arab Bank working with local agricultural cooperatives.** Total funding for this program is US$1.5 million. IFAD assumes 75% of the default risk and Arab Bank the rest. Loans up to US$8,000 are granted to

individuals for terms of 2-3 years. The interest rate is variable and set at LIBOR plus 2.5%. 1.25% is returned to the cooperative after repayment to cover operating and administrative costs of loan assembly, follow-up and recovery. In addition the cooperative charges a 30 shekel loan generation fee and a 50 shekel loan origination fee. The local cooperative provides additional technical assistance to its borrower members as needed.

Loans require two guarantors, at least one of whom must be an employee of an established and stable enterprise whose wages can be garnished in case of default. Additional guarantees, such as notarized deeds, are generally required.

The repayment rate on these loans is reported as 88%, but improving. None of these loans are expected to default because of the co-guarantors. To date, $500,000 have been disbursed. Initial loans were disbursed late in 1995 so it is too early to determine how well the program will operate.

4. **The Women's Loan Fund for the Gaza Strip** was also initiated in late 1995 and is, therefore, to early to assess. Funding is provided by ANERA and the American Jewish World Service. The fund is managed by the Free Thought and Culture Association (FTCA), a Palestinian Women's NGO in Khan Younis in the Gaza Strip. Total funding level is $300,000. ANERA would like to expand this program to other local NGOs.

Loans are targeted to low income women for income generation and job creation. The maximum loan amount is $5,000 at 8.5% from which 1% is given to the Bank of Palestine for the disbursal and receipt of funds from the ANERA account. Appropriate guarantees are required.

The fund has one credit officer whose salary is paid by ANERA but who is officially employed by the FTCA . The credit officer is provided with a vehicle and works with seven women's groups, each of which serves as the credit committee evaluating applications from its area.

ANERA provides training both for the woman credit officer, and the members of the credit committees. ANERA is seeking additional funds for this program.

With considerable experience in a variety of credit programs, ANERA has not made the hard decisions necessary for these activities to become operationally self-sufficient in the medium term and sustainable in the long run. While all the ANERA programs are charging positive real rates of interest, none of them charges enough to become operationally self-sufficient.

ANERA is struggling to shift from a refugee relief focus to financial institutional development. ANERA's contribution to alleviating constraints to poor households during the difficult Intifada period is unquestioned. Althoug ANERA is insisting on cost recovery and stricter financial discipline in its programs, there remains an anti-usury mentality that will make it difficult for ANERA programs to scale up, or even achieve operational self-sufficiency in the reasonable future.

OTHER RELEVANT CREDIT PROGRAMS

The **Palestinian Development Fund** (PDF) is the new umbrella under which three exiting Palestinian NGOs are being merged to provide financial services to the small and medium enterprise sector in West Bank and Gaza. Because they have recently begun increasing their loan sizes, they can no longer be considered a microenterprise lending source. While many of the firms that they lend to have ten or fewer employees, the capital assets of these enterprises, excluding land and buildings, generally exceeds $50,000.

The principal donor for these three NGOs is the European Union which has encouraged the merger to increase administrative efficiency of the programs. Of the three, the Economic Development Group (EDG) and the Arab Development and Credit Co. (ADCC) began making a significant number of microenterprise loans during the Intifada. The recovery rates on these loans has been poor, due to high transaction costs of lending, poor enforceability of security contracts, and due to a lack of serious financial discipline in the loan evaluation process.

These factors have changed for the better in recent years. Under the new Palestinian Authority enforcement of contracts is much easier than under the Israeli military authority. Lending decisions are now being made on their financial merits rather than for political reasons The financial management of all three institutions has improved.

As a result of the poor performance of the microenterprise portfolio of EDG and the ADCC, both programs have decided to drop microenterprise loans and to target small and medium enterprises.

The **Arab Development Credit Corporation (ADCC)** has focused largely on financing agricultural projects with a smaller portfolio of industrial and services loans. The ADCC began operations in 1985 and has lending services in both the West Bank and Gaza. The Gaza unit began with a loan capital of $500,000 and is administratively autonomous. Loan terms are for 1 to 3 years. Borrowers pay 7.5 % interest on loans less than three years and 8.5% on loans three years or longer.

As of January 1996, the ADCC had 975 loans on their books representing US$7.12 million, for an average loan size of

122

US$7,300. Repayment rates have been very low, but are improving. The current repayment rate approaches 70%, which is almost twice the recovery rate of previous years. This improved recovery rate is due to improved collateral enforcement procedures that are possible under the new Palestinian Authority and new management at the ADCC.

The ADCC has no provisions for writing off bad debts at this time. The repayment rate for new loans is high, as these loans are secured by guarantors and physical collateral. With improved management, the ADCC should be able to sustain high recovery rates in the future. Current interest rates are probably high enough to cover operating and administrative costs, if the recovery rate were higher. However, cost of capital is not considered in the current interest rate figures.

The **Economic Development Group (EDG)** started in 1987 with the original lending focus on women, released prisoners, and students. Most of the loans during this period could be considered microenterprise loans. In 1992, the EDG decided to shift its focus to small and medium enterprise lending and to the financing of tourism and light industrial activities. Most loans are now for existing businesses, though the EDG will occasionally finance new business start-ups.

The EDG has four branches and a staff of 20, eight of whom work as loan officers. Since its inception, over $10 million have been disbursed, 60% of which since 1993. The maximum loan size is US$400,000 or 50% of the value of invested capital in the enterprise excluding land and buildings. Eighty percent of all loans are under $10,000. Loans are offered for up to five years at 8.5% or up to 3 years for 7.5%. Both guarantors and collateral are required. Repayment rates on loans disbursed since 1993 are above 90%. The EDG does not write off uncollectible debt, a policy which inflates the value of their assets, while pulling down their recovery rates.

The **Technical Development Corporation (TDC)** has focussed on medium and large scale industrial and tourism activities and is the newest and most commercial of the three NGOs about to merge. The first loans were made in 1990. Loans size is from $50,000 - $100,000. Repayment rates are 92% for loans over 90 days past due. The interest rate of 7% charged on loans defrays but does not cover TDC operating costs, which are estimated at 9% of funds lent.

Like the ADCC and the EDG, the TDC has no accounting provisions for bad debt loss, but plans to implement a 5% bad debt loss provision this year. The TDC attributes its higher repayment rates on tighter management and the fact that they do not make small loans.

All three of the NGOs about to merge have abandoned their micro-lending portfolio because the do not believe it can be as profitable as lending to larger firms. The European Union agrees with their assessment and has encouraged the increased loan size and services to larger enterprises.

Cooperation for Development (CD) is a UK-funded program that has been operating in the West Bank and Gaza since 1983, targeting small and medium enterprises. Originally tied to the UNRWA program, CD split off in 1992. Like all of the other NGOs providing loan funds before and during the Intifada, loans were often perceived as grants by the loan recipients. In the absence of being able to enforce loan contracts, defaults were high.

CD provides loans to small and medium firms for 1 to 3 years for 7% per year simple interest. Loans are granted through three commercial banks, the Cairo Amman Bank, the Bank of Palestine and the Jordan Bank. CD's goal is to create linkages with commercial banks through the creation of small guarantee funds. These funds enable the banks to lend to small business clients without taking on the risk. CD finances up to 50% of the project excluding land and buildings.

The CD has no bad debt provisions. A total of 78 loans were made last year. Seventy percent of CD loans have been made to start-up businesses. CD has extremely high overhead costs, given its small loan portfolio. While assistance to new start-up businesses is arguably important in the WB/G, the failure rate of new start-ups worldwide makes it extremely difficult to achieve good cost recovery in financing new businesses.

The **Cooperative Housing Foundation (CHF)** received funding from USAID in 1994 of US$25 million for a project in Gaza. As of January 1996, approximately $1 million had been extended for housing improvement loans with an additional $3 million to be authorized by September 30th. These loans are generally in the US$6,000 - 7,000 range and all channeled through the Arab Bank. In addition, the project will finance the construction of 192 apartments to be sold to low income families.

As of the time of this study all payments had been made in full and on time. It is not clear whether the Arab Bank would consider assuming management and funding of this portfolio, without donor support.

ANNEX 10

CASE STUDIES OF SELECTED MICROENTERPRISE OPERATORS

Overview of Microentrepreneurs in the WB/G

This annex provides a description of microenterprises in the West Bank and Gaza. These case studies are not representative in a statistical sense. These case studies are drawn from interviews with 26 microentrepreneurs during this assessment. Time and budgetary constraints necessitated that we visit firms that already had some contact with one or more NGOs. The following case studies are illustrative as they point out the range of microenterprise activities in the West Bank and Gaza. The names and locations of the operators have been changed to protect their anonymity.

Consistent with findings on microenterprise growth and dynamics worldwide, the vast majority of microenterprises in the WB/G resemble the activity in Case Study 1. The findings of Mead and Liedholm from the GEMINI studies suggest that some two-thirds of these firms will not grow in numbers of employees. Directing financial services to this group does not necessarily achieve significant employment impact in terms of increased numbers of employees. It may, however, often decrease unemployment or underemployment on the part of family members of the microentrepreneur. It also can have a significant impact in improving household incomes and alleviating poverty. Since a large number of microenterprise operators in this "low growth" category are women, providing sustainable access to financial services to this group, also is a very effective means of ensuring that women are not marginalized out of the development process.

A surprising number of microenterprise operators interviewed were quite entrepreneurial in their outlook and had specific plans to expand their business in terms of volume of sales, value of capital stock, and numbers of employees. Much of the intended employment expansion, however, was directed to reducing underemployment among family members. Most of the firms we contacted in this "moderate growth" category were operated by women. This was due to the sample selection process and not to any gender dynamics of microenterprises in the WB/G. It suggests, however, that a large number of women-operated microenterprises are growth oriented and plan to add 2-5 workers in the next few years.

A much smaller number of microenterprises contacted were aggressive growth-oriented firms. These firms were more capital intensive than most low or moderate growth firms. The level of invested capital in the WB/G, excluding land and buildings, is very high compared to high growth microenterprises in other developing countries. It is more reminiscent of micro and small scale enterprises in developed countries. High growth potential microenterprises make up about 10% of microenterprises in parts of the world where microenterprise surveys have been conducted. Ten percent of these firms are likely to expand the point where they operate with ten or more employees.

The capital intensive nature of many of these firms makes it difficult to serve them with traditional microenterprise loans. Regardless, these high growth potential firms should not be excluded from a microenterprise credit activity. Many of these firms, like Beth-Esmine Plastics (Case Study 4), have short-term working capital needs that are unlikely to be met by commercial banks. More importantly, high growth potential microenterprises are greater in number than all of the medium and large scale enterprises combined. In the WB/G, if one percent of all microenterprises were able to hire an additional ten workers, the employment impact could be an additional 15,000 new jobs. This is a greater employment impact than might be realized with any major public works project, or a doubling of jobs among medium and large scale firms. Significant growth, defined as adding at least ten workers, occurs in about one percent of all microenterprises in countries where microenterprise baseline surveys have been conducted. (Liedholm and Mead, 1993)

A final observation concerns women-operated microenterprises. In many societies, women's enterprises fit into an overall household income enhancement strategy. Women's economic activities tend to be less capital intensive so that the costs of entry and exit are low, enabling women to shift from enterprise operation to household activities such as child rearing. In the cases studied, many of the women's economic activities were the sole source of household income.

The apparently high rate of incarceration of husbands and sons during and after the Intifada, worker disability, and unemployment due to the reduction in work permits in Israel, have created both opportunities and obligations for women. Women's microenterprise activity is accepted, particularly when male household members are absent, disabled or unemployed.

The following boxes illustrate the range of microenterprises and their dynamics observed in the WB/G.

ML

Case Study 1 Naffisa Abdullah, Sweet Seller

Mrs. Abdullah lives and works in a refugee camp in the West Bank. She makes traditional sweets and augments sales by buying and reselling manufactured sweets. She uses the income from her sales to support her family of five. She operates out of her home, does not keeps books, nor pay any taxes for her enterprise. On occasion, family members or close friends will help her out when she has larger orders to fill.

She is one of thirteen members of a Save The Children Foundation Solidarity Group. Her business, like that of the other members of her group, is not sophisticated, requires little capital, and has a high turnover. Mrs. Abdullah does not plan to employ more people, she just wants to be able to earn enough to support her family.

As a member of the SCF group, she took out her first loan for JD200 ($300). She plans to take out additional loans and would like eventually to borrow more than the SCF maximum of JD 350. She does not know from where she might be able to borrow more than JD 350. She uses loan capital to purchase ingredients for her sweets.

She is developing her management skills, recognizing times when her product sells better, and marketing her sweets to potential clients in advance of special events such as marriages or baptisms. She also manages to save with the other members of her Solidarity Group in an account in the Bank of Jordan.

Mrs. Abdullah is typical of many microenterprise operators. Her business will not expand significantly since that is not her objective. Loans to these types of firms are used to alleviate borrower poverty and to improve (and in some cases diversify) household income.

Case Study 2 Raissa Affana

Raissa Affana operates a market stall in the Beach Camp in the Gaza Strip. For three years she worked in the frippery market, buying clothes in Jordan and reselling in Gaza. Two years ago she added rabbits, pigeons, chickens and ducks to her sales activities. Like many microenterprise operators, Mrs. Affana sells whatever she can and is not committed to specialization.

Her business does well and she is able to turn over her inventory every 2-3 weeks. With her husband disabled and two sons in jail since the Intifada, Mrs. Affana is supporting 25 people with the income from her market activities. Her hopes are to open a small poultry shop where she will slaughter the animals she sells. She keeps her own books and says she has benefitted from the basic book-keeping training she has received from UNRWA.

Mrs. Affana is a member of the UNRWA Solidarity Group Lending program. She is in her second loan cycle and has about $1,000 outstanding. With her third loan, Mrs. Affana hopes to purchase chairs which she plans to rent out for baptisms, marriages and other celebrations.

She is aware that as a group member, the Arab Bank will pay her 10% on Shekel deposits. She would like to save more but says with the large group that she is feeding, savings is very difficult. She has been a member of informal savings groups *(jamiiyaa)*, but is not presently.

Case Study 3. Fatima Nabesch, Proprietor, Market Vegetable Stand

Mrs. Nabesh has operated her family vegetable business since her husband was imprisoned 5 years ago. She buys and resells vegetables but is hoping to be able to rent enough land so that her sons will have employment producing vegetables for sale. Mrs. Nabesch is supporting 5 adults with her income from the vegetable stand.

She is a member of the UNRWA Solidarity Group Lending Program. One of seven members of an UNRWA solidarity group, Mrs. Nabesch was contacted by a friend who was responsible for starting the group. She is very happy with the UNRWA group, but wishes she could borrow more. She likes being part of the Solidarity Group because it is a way for her to discuss with other women how to better manage their business.

Like most of the borrowers contacted who participated in the UNRWA program, Mrs. Nabesh had no problems repaying her loan at an effective interest rate of over 40%. Mrs. Nabesh has just finished repaying her second loan of NIS2,000 (US$600) and is now eligible to borrow NIS4,000 for a period of 9 months.

In spite of working in a relatively competitive business, Mrs. Nabesh says business is good and growing. Her sons and husband help her in the business, but she realizes that they are underemployed. For this reason she plans to use her next loan to rent a plot of land for her sons to farm.

Case Study 4: Ali Eid Abdallah, Owner-Operator Beth-Esmine Plastics

Ali Eid Abdallah is in his mid-thirties. He owns and operates the Beth-Esmine enterprise, a small plastics extrusion factory that has been in business for two years and has three employees. Like many small manufacturing activities in the West Bank and Gaza, Mr. Abdallah's enterprise is very capital intensive. The value of Beth-Esmine's capital, excluding land and buildings, is about US$150,000. Most of this value is in one extrusion machine. Mr. Abdallah obtained a US$57,000 loan from the Economic Development Group, representing about one third of the machine's purchase price. The remainder of funds came from Mr. Abdallah's family.

Beth-Esmine Plastics manufactures small plastic bottles which are sold primarily in Israel, with a smaller share sold to Palestinian firms in the West Bank and Gaza. Sales to Jordan are not possible because of the tariffs imposed by the Jordanian Government.

Liquidity is the major constraint to growth and expansion of the Beth-Esmine factory. In order to rapidly turn over his inventory and to secure customer loyalty, Mr. Abdallah must sell almost 80% of his inventory on short term credit, while he pays cash for all his inputs. Mr. Abdallah has occasionally borrowed money from money-changers in order to pay salaries or purchase inputs. The money changers charge him 5% per week on the unpaid balance. He gives the money-changers post-dated checks as guarantees.

The US$57,000 that Mr. Abdallah borrowed from the EDG is a three year loan. Mr. Abdallah was required to provide two personal guarantors, and mortgaged his house as collateral.

Mr. Abdallah would like to be able to access loans in the US$3,000- 5,000 range at lower rates than those charged by the money-changers. He has both working capital and fixed asset needs that fall within the 3,000-5,000 dollar range. In addition to needing to purchase inputs and pay salaries on a regular basis, Mr. Abdallah would like to purchase additional molds which cost just under US$5,000 each.

ANNEX 11

INTEREST RATES AND MICROENTERPRISE LENDING

Comment on Interest Rate Terminology

Interest rates alone and unqualified can be misleading. Simple, nominal, effective, and real are the some of the terms used to describe interest rates. Generally, lenders express their interest rates as "simple" because simple interest tends to yield the lowest value. Throughout the WB/G sector assessment, interest rates are expressed in whatever terms the lender uses, and it's effective rate. The effective rate of interest is the discount rate at which the stream of payments of principal plus interest equals the present value of the loan principal.

Concern for interest rates is a misleading issue in microenterprise lending. Small loan amounts and short loan terms cause the loan assembly costs to be a relatively high percentage of principal lent. Interest rates have no basis for comparison in isolation from term and principal. The nominal interest rate of the SCF program is 22%, UNRWA charges 24%. The effective annual rate of the SCF and UNRWA programs ranges is much higher. The effective rates of interest of these two and other successful microenterprise programs tends to be significantly higher than rates charged by commercial banks.

Real rates of interest are adjusted for inflation. Adjusting interest rates for inflation is important because it provides a measure of how money is holding (or losing) its value over time. The effective rate which includes the costs of funds has inflation added in the cost of those funds. If the rate of inflation is high, the effective lending interest rate must cover the inflated cost of funds as well as the cost of lending. Whenever inflation is positive, the effective rate interest rate will be higher than the real rate. The real rate of interest is the effective rate minus the inflation rate.

All of the NGO and commercial banks contacted during this study protect themselves against the inflation of the New Israeli Shekel (NIS), by pegging repayments to either the Jordanian Dinar (JD) or the American Dollar (US$). Because the rate of inflation of the dollar and the Jordanian dinar is low, the effective interest rate calculated below, and the real interest rate are very close.

Borrowers however, are paying an effective rate higher than the one calculated below, because their repayment is tied to the dollar or dinar, but they repay in shekels. Assume that the dollar inflation rate is 3%, and the NIS inflation rate is 10% (these figures are fairly close to the situation at the time of study). If the effective interest rate charged by a microenterprise lender is 45%

tied to the dollar, the difference in inflation rates between the NIS and the dollar is 7%. The effective rate paid by borrowers is 45% +7% = 52%. The real rate of interest is the effective rate minus the inflation rate or 45%- 10% = 35%.

The real rate of interest not so important to a financial institution's viability and for this reason, real interest rates were not included in this report. All of the institutions visited were aware of how inflation can rapidly reduce the value of an institutions portfolio, and all had adopted procedures to hedge against inflation. It should be noted that the imputed rates of interest charged by the informal sector (60%-300% per annum) are effective rates, i. e., not adjusted for inflation.

Comparing microenterprise loan rates with commercial bank lending rates is like comparing apples and oranges. The products are different. A more appropriate measure against which interest rates can be subjectively interpreted as high or low, are the costs of delivering microenterprise loans.

This annex demonstrates the calculation used to determine the effective rate of interest charged by the various programs described in this study and illustrates the need to set interest rates to cover the costs of lending.

Calculation of Effective Interest Rates

To demonstrate the calculation of the effective interest rate, actual loan figures from SCF are used below.

SCF provides short term working capital loans to women. For first time borrowers, loan principal is JD 200 (about $300) for six months. Payments are made bi-monthly. The interest is set at 11% of principal for the six month period. The annualized rate is 22% simple.

In December of 1993, SCF made a loan of JD 2,400 to a group with 12 members. There was a loan origination fee of JD 24 which reduces the loan principal to 2,376. The loan term is six months with semi-monthly payments due. The interest is 11% of principal (before the origination fee is deducted) is set at JD 264. There are 12 loan payments. Payments are calculated as $(P + I) \div 12$ = JD 222.

131

To calculate the effective rate of interest we need to calculate the discount rate at which the stream of payments equals the loan principal. To do this we need to calculate the rate of interest for each of the semi-monthly loan payments using the following formula where:

$$Principal(PV) = 2376 = \sum_{t=1}^{12} 222 \left[\frac{1}{(1+k)^t}\right] = 222\ (PVIFA_{k,12})$$

PV = present value;
t = period in which payments are made;
k = the discount or interest rate;
$PVIFA$ = the Present Value Interest Factor for an Annuity.

To solve for $PVIFA_{(k,12)}$:

$$PVIFA_{K,12} = LoanPrincipal \div PeriodicPayment = 2376 \div 222 = 10.703$$

Extrapolating from a standard Present Value of an Annuity Table for 12 periods, the value 10.703 yields a periodic interest rate of 1.84%. Multiplying the periodic rate,1.84%, times the number of semi-monthly loan periods in a year (24) we arrive at the effective interest rate of:

Periodic rate (1.84) × Number of periods per year (24) = Effective annual interest rate (44.16%).

Using the above formula, we can calculate the effective interest rate for the other NGO programs. The UNRWA Solidarity Group and Microenterprise Credit programs charge and effective rate of 41.5%; CARE lends at an effective rate of 40.15%; ANERA lends at effective rates of 15.1%-15.3%. Commercial banks lend at effective rates close to the ANERA rates.

Costs of Lending

Why the disparity between the SCF,UNRWA and CARE programs which all charge effective rates of greater than 40%, and the commercial bank and ANERA rates which charge around 15%? ANERA's rates are lower because they are tied to commercial bank rates, and have no bearing on ANERA's actual lending costs. Bank rates are different and lower than successful microenterprise credit rates, because the costs of granting, following up on, and recovering commercial bank loans is much lower as a percentage of funds lent, than those for microenterprise loans.

Each loan application regardless of size must be reviewed; all loans made require follow-up to ensure timely repayment; and, all delinquent loans require additional follow-up and recovery procedures to ensure recovery of the loan. The costs of these procedures do not vary near as much for very small versus very large loans as do the loan sizes.

Assume for a moment that for a microenterprise loan of US$300, the loan generation, follow-up, and recovery costs are 75 dollars. This is 25% of the principal amount. If the cost of capital is 11% and the repayment rate is 95%, the minimum cost of funds lent is 25% + 11% + 5% (bad debt losses) = 41%. At any interest rate below 41% in this example, the loan will lose money.

For commercial banks the procedures for evaluating loans tends to be more costly. Assume that for a commercial bank, the per loan generation, follow-up, and recovery costs are four times as high or US$300. The minimum loan size of made by the commercial banks visited in the West Bank and Gaza is US$5,000. For the smallest of commercial bank loans the cost of lending funds is $5,000/$300 = 6%. Banks are able to borrow funds from international markets with a current cost of funds (LIBOR rate) of about 5.5%. Assuming the same bade debt loss ratio, commercial bank cost of funds lent is 6% +5.5% +5% = 16.5% or 40% of the cost of making a microenterprise loan.

The above hypothetical costs assume that the lending institution has already achieved scale. This is not yet the case for any of the NGO credit institutions in WB/G that lend to microenterprises. SCF estimates that its cost of lending funds (excluding the cost of capital for 1996) will be 66%, dropping to 33% in 1997, and to 12% by the year 2000. If we add in an estimate of the cost of funds of 11%, SCF will not be able to cover its costs of lending through interest fees until 1998. This is also assuming that SCF will be as effective at containing costs as they have included in their projections. In this context an effective interest rate of 44% does not seem high. If the rate were any lower, the program would never be able to become sustainable.

Thus, it is erroneous and misleading to base microenterprise interest rates on commercial bank lending rates. Commercial bank loans and microenterprise loans are different instruments with different terms and different costs. Comparing the two is an "apples and oranges" argument. Basing microenterprise lending rates on informal lending rates would be more appropriate. <u>The most appropriate means to determine interest rates for microenterprise loans, however, is not by comparison, but rather on a careful estimate of the costs of making those loans</u>.

133

ANNEX 12

EGYPT TRIP REPORT

In order to broaden the base of knowledge of regional models for microenterprise credit for the West Bank/Gaza Mission, a field trip was carried out to Egypt during the period of January 21-25, 1996. Two members of the Private Sector Office, AID/WB/G and two of the consultants joined in the trip. The team was provided briefings and materials from AID/Egypt, one bank, two foundations (and two of their branches), and a guarantee corporation.

There are two distinct models for delivering microenterprise credit in Egypt: one is being carried out through non-governmental organizations made up of local business leaders, or "Foundations" in Egypt; the second model is being implemented by a bank. Both the foundation and bank models have benefitted from monetary support and technical assistance from AID/Egypt, and to various degrees are still enjoying that support and leadership.

Foundations

A fairly thorough description of one of the foundations, the Alexandria Business Association (ABA), is contained in a separate annex to this report. That model represents work now being carried out by other foundations in Egypt, currently in Cairo and Port Said, with other foundations just beginning end-use lending. While each of the foundations are separate legal entities, the models set by Alexandria are being generally followed by the other foundations. The newly emerging foundations are receiving direct technical assistance from the ABA, as well as other expatriate and domestic services contracted by USAID/Egypt. Currently, the Egyptian Small Enterprise Development (ESED) Foundation in Cairo is issuing nearly as many loans on a monthly basis as is the ABA, with similar repayment patterns (generally in excess of 98% on-time repayments). Both the ESED and the ABA were directly interviewed during the course of the visitation to Egypt.

Both the ABA and the ESED began lending in 1990. The ABA has gone through a steady growth since its beginning, with a very stable senior management structure, as described in Annex 6. The ESED had more difficulties in its earliest years in establishing a firm senior management structure, but is now, on a monthly analysis, equalling the ABA performance. Both the ABA and ESED are operating on the positive side of a breakeven basis, with excess income being poured back into a growing account to support expanded lending.

The chart below shows some gross figures for comparison between the two largest and longest standing foundations in Egypt that are dedicated to the responsible delivery and recovery of microenterprise credit. Average loans sizes for both organizations are around $1,000-$1,200.

Comparative Chart
Alexandria Business Association and
Egyptian Small Enterprise Development Foundation

Name of Organization	Current Outstanding Loans (No.)	Current Outstanding Loans (Amount)	Total No. of Loans since Beginning	Total Am't of Loans since Beginning	Total Branches
ABA	21,000	$7.63 mil.	47,000	$36 mil.	8
ESED	9,800	$6.2 mil.	23,500	$20 mil.	8

The National Bank for Development

The National Bank for Development (NBD) was founded in 1980 as a private, for-profit banking institution under Egyptian Law 159. Although NBD is technically private, around 95% of its shares are held by public companies. The original focus of NBD was to provide funding for relatively large factories and processing plants in the rural areas of Egypt, with an eye to providing employment in those areas that might stem the flood of job-seekers to the metropolitan areas.

NBD has gone through a lengthy development phase in the delivery of microenterprise credit, with donor involvement that has included not only USAID, but Ford Foundation, CIDA, and the World Bank sponsored Social Development Fund. NBD's earliest exposure to microenterprise credit was during 1986-7 when AID sponsored a study trip to Bangladesh for a few key personnel, and Ford Foundation began to carry out research in one rural "governorate", an administrative subdivision of Egypt.

Middle management of NBD began to see strong possibilities for microenterprise credit in Egypt, but initially still in the more rural areas. It successfully applied to AID for grant funding and expatriate technical assistance in 1987 to carry out a pilot project in four sites; two each in the two rural governorates of Sharkaya and Damietta in the Nile Delta areas. Although there were the standard fits and starts in initiating the pilot project, an evaluation commissioned by AID/Egypt and was carried out in 1990. Certain minor problems were identified, but the project had exceeded all targets and expectations. AID pursued negotiations with NBD for joint funding of a follow-on project to be carried out in the metropolitan Cairo area. The project is generally referred to as the Small Enterprise Credit Project (SECP) by both NBD and AID.

Lending under the SECP began in earnest in late 1993, with some fairly impressive results to date. Defaults are generally unknown, and late payments are generally less than 1% of the total portfolio. Average loan size is about $750 per borrower.

135

NBD Performance Chart

Name of Organization	Current Outstanding Loans (No.)	Current Outstanding Loans (Amount)	Total No. of Loans since Beginning	Total Amt. of Loans since Beginning	Number of Branches
NBD	15,148	$8.7 mil.	63,300	$49 mil.	13

Credit Guarantee Corporation

The Credit Guarantee Corporation (CGC) was also visited during the course study tour of Egypt. Although the CGC model might not be applicable to the status of microenterprises in WB/G at this point in time, some of its approach might be useful in the future.

The CGC went through a process of research on worldwide models of guarantee corporations beginning in 1987. By early 1989, it appeared that the formation of a privately-held guarantee corporation for small businesses was feasible in Egypt, and actual formation of the CGC began. AID/Egypt's contribution to the CGC was primarily in the form of expatriate and domestic technical assistance.

There are ten corporate owners of the CGC, nine banks and one insurance agency with total paid up capital of slightly less than $700,000. The CGC acts as a guarantor to banks which are extending loans that have less collateral than is usually required, in which case the CGC takes a risk position on the loan for a fee, generally 2% of the amount insured. In most cases, the CGC guarantees no more than 50% of the loan. Although the CGC was originally chartered only to provide guarantees for loans for small business, it later opened a window for guarantees to health care practitioners, in a joint funding arrangement with USAID/Egypt.

To date, the CGC has extended guarantees for nearly $200 million loans over 5 years, with a default (payout rate) of around .03%. Thirty-two banks have signed memorandums of agreement with the CGC, but twelve of the banks are providing most of the business to CGC. It is perceived that the CGC has provided the initiative to the banks to provide loans that they would normally not have made.

ANNEX 13

TRIP REPORT - AMMAN, JORDAN

Background

The Team Leader traveled to Amman, Jordan for two days to review the programs currently underway to finance microenterprise development in Jordan. Since the Team Leader has worked in Jordan a number of times over the past few years, he was aware of the key organizations providing support to microenterprise development. This trip was to update his knowledge on the activities of those organizations in order to apply any lessons learned from those activities to the current microenterprise sector assessment for the WB/G.

The principal organizations currently active in microenterprise development in Jordan include Save the Children Foundation (SCF), the Noor Al Hussein Foundation (NHF), and the Queen Alia Fund for Social Development (QAF). Meeting with held with representatives of each of these organizations to discuss their programs. In addition, we met with Khaled Al Naif, the USAID/Jordan staffperson responsible for managing both the USAID/Washington-financed Loan Portfolio Guarantee (LPG) Program for the WB/G and the USAID/Jordan-financed Jordan Loan Guarantee Corporation. The following paragraphs summarize these various activities dealing with microenterprise development and their potential applicability to the WB/G for the proposed microenterprise finance project.

Save the Children Foundation (SCF)

The SCF Middle East Regional Office is based in Jordan, so we discussed the programs of the SCF in Jordan as well as the Middle East, in general with the Regional Director, Mark Eldon-Eddington. The Group Guaranteed Lending and Savings (GGLS) strategy to address microenterprise finance is an approach utilized by SCF in all the countries in which it is active in the Middle East. Therefore, the program implemented in the WB/G is very similar to that implemented in Jordan (as well as Lebanon and Egypt). This activity specifically targets low-income women.

As of the end of 1995, the Jordan program had a total of 800 active clients who had received loans from SCF. The program claims 100% repayment. Originating as a pilot project with funding totalling US$120,000 from SCF and other donors, this program has since received $1.5 million combined from USAID/Washington and USAID/Jordan to expand the program over three years in both urban and rural areas. The methodology for the program in Jordan is very similar to that utilized by SCF in the WB/G, so further details on the Jordan program are not necessary.

Noor Al Hussein Foundation (NHF)

Being one of the principal local NGOs in Jordan which is sponsored by Queen Noor, the NHF is very active in a number of broad areas including family and community development, women-in-development, children's welfare, promotion of culture and heritage and advancement of education. The specific program which deals in microenterprise finance is as aspect of the Quality of Life Project (QLP), which falls under the family and community development area of NHF's activities.

The QLP started in 1989 with a grant from the World Health Organization (WHO) and was based on a WHO financed project in Thailand. The approach is to help families develop economically and socially in order to improve the health of the family members.

Loans provided un the QLP are range from animal raising to fish ponds and beekeeping. Amounts are in the range of JD300 to JD400 (approximately US$450 to US$600) per family. Loans are made either in-kind or in cash. In-kind loans are usually made for animal raising activities and are repaid at the end of the season. Cash loans are generally for three years with a grace period of six months. Interest is not charged. To date, 710 loans have been made.

The loan funds are managed by clusters of families organized by Village Development Councils formed by the NHF. NHF funds Village Development Funds which vary from JD4,000 to JD16,000, depending upon the size of the village. The NHF representative could give no figures for repayment rates, but he stated that they had problems with decapitalization of loan funds. 25-30% of the grant from WHO goes toward administration fees for NHF.

The heavy subsidies in this program make it of little use for the design of the proposed microfinance project in the WB/G.

Queen Alia Foundation (QAF)

The QAF is also a local NGO and is involved in a broad array of social and economic activities. It is sponsored by Princess Basma, the King's sister. It has established some fifty social centers throughout Jordan from which the various programs and projects are administered and promoted.

The Revolving Funds Project (RFP) started in early 1992 at is a poverty alleviation project. Loans are given to families to run economic projects needed by the local community. The maximum amount of credit is JD6,000 (US$9,000) with a six month grace period and a period of six years to repay. No interest is charged, but a 4% management fee is charged. Agricultural loans have a maximum of JD3,000. To date, approximately 600 loans have been made in various sectors, with the majority in the service, agriculture and handicraft sectors. In-king loans are preferred, although some cash loans are given. Loans are split roughly 50/50 between men and women borrowers. Types of projects funded to date include ceramics, wool dyeing and rug weaving, goat and sheep raising, cloth and silk printing, palm tree planting, beekeeping, and tailoring.

A new income generation credit program was started a few months ago where a maximum of JD500 loan is made to a household. About 20 loans have been made in this category to date. Solidarity groups have not been used for these loans yet, but some consideration is being given to this approach. Priority is given to start-up businesses.

The loan program is administered from headquarters in Amman where all loans are approved. Promotion and monitoring is done by staff in the QAF centers around the country.

Again, the highly subsidized nature of this credit program makes this program a less desirable model for the proposed microfinance project in the WB/G.

Loan Portfolio Guarantee Program (LPG)

This program is financed by USAID/Washington and is reviewed in the text of this report. The LPG in WB/G is managed by Khaled Al Naif, and USAID staffperson in Amman. Mr. Al Naif suggested some bank officials in the Jordan National Bank and the Cairo Amman Bank to interview who are responsible for the LPG in their banks in the WB/G. Although the LPG was not really set up to serve microenterprises, it does appear that the program has resulted in some loans at the lower range (JD5,000 - 6,000), particularly by the Jordan National Bank.

Mr. Al Naif noted that much activity often follows his monitoring visits to the banks in the WB/G. He suggested that increased monitoring might result in increased activity under the LPG; this appears to be a reasonable suggestion.

An notable aspect in regard to the creation of the LPG was that the banks originally considered over a year and a half ago as strong candidates to participate in the LPG dropped out and others, who were not considered initially, have actually signed up for the program. This has important implications for the establishment of a microfinance project in the WB/G through a commercial bank. Initial interest in a program or new idea does not always result in the fruition of the idea. USAID/WB/G should recognize that the identification and establishment of a commercial bank-run microfinance program could take considerable time and might have several changes of course until a bank actually finds the will and accomplishes the requisite policy changes to implement such a program.

Jordan Loan Guarantee Corporation (JLGC)

The JLGC was established in April 1994 with a staff of 12 persons (8 technical) seconded from the Central Bank of Jordan (CBJ). Its mission was to provide guarantees to Jordanian banks which extend working capital loans to Jordanian companies. It began providing guarantees in October 1994. Its capital is currently at JD7 million and consists of the original $6 million from USAID as well as another $5 million from shareholders. It has 24 subscribers consisting mainly of commercial banks, specialized credit institutions, and the CBJ, all of whom have paid 50% of their capital contributions.

The JLGC has actively promoted the guarantee fund both to the banks and to prospective entrepreneurs. It has guaranteed a total of 205 loans to date for a total of JD4.2 million.

The maximum loan guaranteed is JD40,000 and a 50% guarantee is provided to member banks for a 1.5% premium on the maximum amount of loan funds guaranteed. Member banks can increase or decrease the loan fund ceiling on a quarterly basis. If the loan is less than JD20,000 or the loan is to a woman or a rural business, the guarantee can be up to 75% of the loan amount. The loan repayment period is up to 6 years with a maximum grace period of one year.

The bank issuing the loan first approves the loan and then forwards it to the JLGC for their concurrence. The JLGC has refused to issue guarantees in cases where they did not agree with the credit risk assessment of the client. They can agree to guarantee a smaller loan from the client, if they wish. JLGC staff provide training to subscribing banks in cashflow and other non-traditional bases for approving loans.

The most active banks using the guarantee program to date have been the Jordan Investment and Finance Bank, Jordan Kuwait Bank, Bank of Jordan, Housing Bank and the Industrial Development Bank. Interestingly, many of the loans have gone to professionals, e.g., doctors or engineers, to buy equipment to set up practices/businesses. This is very similar to the experience of the Credit Guarantee Company for Small Scale Enterprises in Egypt which was established with USAID financing for similar purposes.

ANNEX 14

USAID

Microenterprise Development Brief
Number 11 September 1995

Small and Microenterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries[1]

The purpose of these principles is to establish common standards for donor agencies to apply in supporting broader access to financial services for micro and small enterprises.[2] Such enterprises have historically lacked access to the formal financial system, but the growing success of many institutions provides confidence that access can be provided sustainably in many settings. It has now become possible to identify and agree upon the basic principles that support successful micro-level finance, so that donors can work in concert to ensure that lessons of success are translated to the institutions they support.

The framework for donor support to micro and small enterprise finance centers on two equally important and complementary objectives. First, **outreach** embodies the aim of expanding access to increasing numbers of low-income clients. Second, **sustainability** provides the means to expand and maintain outreach. These concepts underpin the guiding principles described here.

Different types of micro and small enterprise clients have different characteristics and demand different services. Hence it is desirable to encourage a range of institutions that use specialized methods to serve their particular market niches. These can include commercial and development banks, credit unions, mutual or community banks, non-governmental organizations (NGOs), finance companies, cooperatives, savings and credit associations, and other specialized intermediaries. At the same time, however, this document is based on the premise that fundamental principles of finance apply widely and must be observed by all institutions if they are to succeed. Moreover, donors must design their support mechanisms in ways that are consistent with best international practices and long-run development of a sound financial system.

---

[1] This document is a joint product of the Donor's Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development. It was inspired by and is largely consistent with the recommended standards for support set out by a UN expert group of leading small and microenterprise practitioners convened by Women's World Banking in January 1994. The donor committees adopted the principles in their current form in June 1995, following consultations with key donor agencies involved in small and microfinance. This document is intended for use by project officers in donor and implementing organizations, managers, and policy makers.

[2] Included in the term micro and small enterprises are a wide range of enterprises (industry, transport, commerce, services, agriculture, etc.) ranging in size from part time, seasonal activities of a single person to small, formal enterprises employing several non-family members.

This statement of guiding principles first identifies characteristics donors should seek in selecting institutions to support. It then describes appropriate forms of donor support. An annex lists reporting standards on outreach and financial performance.

I. Institutional Performance Standards and Plans

Intermediaries seeking support should be able to demonstrate the following characteristics, either in current operations or through credible plans underpinned by concrete measures. Since institutions are at different stages of development, it may be appropriate in some cases to adopt modified standards for limited support to new or transforming institutions.

A. Institutional Strengths

1. **Institutional culture, structures, capacities, and operating systems** that can support sustained service delivery to a significant and growing number of low income clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and mission and vision which create a sense of purpose, ownership, and accountability.

2. **Accurate management information systems** that are actively used to make decisions, motivate performance and provide accountability for funds. Such systems are essential for effective and efficient management.

3. **Operations that manage small transactions efficiently**, with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio (while maintaining portfolio soundness).

4. **Meaningful reporting standards**. Transparent financial reporting that conforms to international standards and allows prospective funders to evaluate performance adequately. At a minimum, the raw data listed in the Annex should be reported, and institutions should regularly monitor financial condition using appropriate financial ratios derived from such data.

B. Quality of Services and Outreach

1. **Focus on the poor**. Evidence of service to low-income clients, women and men, especially clients lacking access to other financial institutions. The focus need not be exclusive, as mainstream institutions such as banks are encouraged to become providers, but it must entail a distinct commitment to reaching the poor.

2. **Client-appropriate lending.** For example, for micro-level clients, institutions should feature quick, simple and convenient access to small, short-term loans, often short-term, that are renewed or increased based on excellent repayments. Use of collateral substitutes (e.g., peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character-based lending for smaller loans, with simple cashflow and project appraisal for larger and longer term loans.

3. **Savings services.** Offering savings mobilization services, where legally possible and economically feasible, that facilitate small deposits, convenient collections, safety, and ready access to funds -- either independently or with another institution.

4. **Growth of Outreach**. Making significant progress in expanding client reach and market penetration, demonstrating both strong client response to services offered and competence in service delivery management.

C. Financial Performance

1. **Appropriate pricing policies**. Offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognizing that poor entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses and a minimum return on equity.[3]

2. **Portfolio quality.** Maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the ongoing viability of the institution. For example, organizations with loans in arrears over 30 days below 10 percent of loans outstanding and annual loan losses under 4 percent of loans outstanding satisfy this condition.

3. **Self-sufficiency**. Steadily reducing dependence on subsidies in order to move toward financial self-sufficiency. Achieving operational efficiency [defined as covering all administrative costs and loan losses with client revenues] within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and financial self-sufficiency [defined as covering all adminstrative costs, loan losses, and financing costs at non-subsidized rates from client revenues] within five to ten years.

4. **Movement toward financial independence**. Building a solid and growing funding base with clear business plans, backed by operational capacities, that lead to mobilization of commercial funds from depositors and the financial system, and eventually to full independence from donor support.

Financial performance standards apply only to activities that are an integral part of providing financial services. If programs also provide non-financial services, such as business advisory services, health, or education they must account for such services separately from financial services. Standards for financial self-sufficiency do not apply to such services, and defining appropriate standards for non-financial services is beyond the scope of this document.

---

[3]It should be understood that costs of non-financial assistance provided to entrepreneurs may continue to receive subsidies. However, it is crucial that these costs be separated from the costs of lending operations, so that the financial viability of lending operations can be assessed.

II. Strategies for Donor Support

Funding based on large, ongoing subsidies with a charity rationale has failed. Such programs have drained resources without becoming sustainable, and have contributed to the mistaken notion that the poor are unbankable. Funders should provide financial and other support in such a way to ensure the quality of services provided and the widest outreach, as well as to foster the movement to scale, financial self-sufficiency, and independence from donor support, taking into account the particular characteristics of different types of institutions. Donors should ensure that institutions, in their effort to become sustainable, maintain a focus on offering appropriate services to the poor.

1. **Appropriate uses for grants.**

   o **Institutional development.** Support for institutional development is appropriate at all stages of an institution's life, and for a wide range of institutions, although the nature and extent of such support should evolve with the institution. Such support should become more selective, as institutions become able to meet more of their organizational development needs from within. It should also become more specialized, as institutions tackle more difficult problems.

   o **Capitalization**, or grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks. One of the key purposes of providing capital funding is to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale. Externally-financed capitalization should be used as a catalyst and complement to domestic mobilization of funds by local institutions. Grant equity contributions can also help institutions seeking to become formal financial intermediaries to meet minimum capital requirements.

   o **Operating losses.** Donors should avoid covering operating losses except during a clear, time-limited start-up or expansion phase. By the nature of the small loan business every program will take some time to reach a break even point. Donors should be willing to provide support during that time. Afterwards, however, such support becomes counterproductive.

   o **Fixed assets**. Donors may wish to support purchase of fixed assets, such as computers, vehicles or premises. Such funding may be seen as contributions to the equity base of the institution.

2. **Appropriate uses of loans.** Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk in loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine savings mobilization efforts of savings-based institutions, such as savings and credit associations by making loans available to them below the cost of mobilizing funds locally.

3. **Commercial sourcing of funds**. The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as:

   - **Investor equity**, from both official and private sources. Donor support can help leverage private investment.

   - **Second-tier operations**, which raise funds from commercial sources and onlend to microenterprise finance institutions.

   - **Partial guarantees** of loans made by commercial banks to NGOs.

4. **Coherence of donor policies**. Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grant or loan) to small and microenterprise institutions, donors should ensure that they coordinate that support with other funders, such that institutions are given clear incentives to become financially viable. In particular, donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied. Donors should also coordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth.

ANNEX: MINIMUM REPORTING INFORMATION:
Raw Data Needed for Computing Analytic Performance Indicators

Donors should require regular reporting on institutional performance and should base funding decisions on achievement of performance targets. It is expected that every institution -- and the donors that support it -- will actively use **analytic indicators** to monitor the institution's financial condition. Examples include: net profit, average loan and savings account size, adjustments for subsidy and inflation, operational and full self-sufficiency, return on assets and equity, administrative costs as a percentage of portfolio (required spread), portfolio yield, and staff productivity. The intent is to ensure the quality and comparability of data so that financial analysis can be conducted in a way that both donors and programs can interpret.

The following tables cover the **minimum raw data** that should be reported, but do not include analytic indicators, such as financial ratios or adjustments for subsidy or inflation. In order to evaluate and compare performance, the raw data will have to be analyzed, through computation of ratios and other indicators. Informed opinions differ on which indicators are most important. Therefore, this document makes no attempt to specify those indicators. Rather, it provides for an information base of raw data to use in the calculation of a range of key ratios.

Portfolio and Outreach[4]

1. Number and amount of loans outstanding at beginning and end of reporting period	
2. Number and amount of loans disbursed during reporting period.	
3. Number and amount of small saver deposit accounts at beginning and end of reporting period. Show compulsory and voluntary savings separately.[5]	
4. Arrears (on a loans outstanding basis). Unpaid balance of loans with payments overdue more than 30 days. There should also be an aging of arrears report, covering, for example, 60 and 90 days and one year.	
5. Percentage of female clients.	
6. Number of staff (only those involved with savings and credit activities).	

[4] For institutions that offer a full spectrum of financial services, information should apply only to that portion of the institution's activities and overheads focued on small and microenterprises.

[5] Many programs require clients to deposit minimum amounts or pay into savings funds in order to be eligible for loans.

Interest Rate Policy

7. Effective annual interest rate paid by clients (incorporating all required fees, and calculated on a declining balance basis), both nominal and real. Effective rate paid to savers.	
8. Local annualized interbank lending rate and 90-day CD rate.	
9. Local annual inflation rate (give source).	

Income and Expense Information

INCOME	
10. Interest and fee income from loans (excluding accrued uncollected interest on non-performing loans)	
11.Income from investments	
12. Other operating income from financial services	
EXPENSES	
13. Staff expenses (salaries and benefits)[6]	
14. Other administrative expenses (includes depreciation)	
15. Loan losses. All loans over one year in arrears should be written off, as far as local rules permit. Institutions should describe their criteria in recording loan losses.	
16. Interest and fee expenses (itemized by source of funds)	
17. NET OPERATING PROFIT	
18. Non-operating income	
19. Non-operating expenses	

20. Donations:	
20a. For operating expenses	
20b.Capital contribution (identify purpose, e.g., loan fund, equity, fixed assets)	

[6]Staff and administrative expenses should be those that relate to the provision of financial services. If an institution has significant non-financial activities, it should account for those costs separately, including the proportion of overhead expenses needed to support those activities. Costs paid directly by donors, such as expatriate salaries, should be included.

Balance Sheet Information

ASSETS	
21. Cash on hand and in banks	
22. Mandatory reserves	
23. Short term investments	
24. Loans outstanding (must match indicator 1, above)	
25. Less: Loan loss provisions	
26. Net portfolio outstanding	
27. Long term investments	
28. Fixed assets (after depreciation)	
29. Other assets	
30. TOTAL ASSETS	
LIABILITIES	
31. Savings and time deposits from target group clients (must match indicator 3, above)	
32. Other deposits	
33. Loans from central bank	
34. Loans from other banks	
35. Other short term liabilities	
36. Other long term liabilities	

EQUITY	
37. Paid in equity (shareholders)	
38. Donated equity	
39. Retained earnings	
40. Other capital accounts	
41. Current year profit or loss	
42. TOTAL LIABILITIES AND EQUITY	