A FEASIBILITY STUDY FOR THE ESTABLISHMENT OF AN INDEPENDENT MICROFINANCE SUBSIDIARY IN THE WEST BANK AND THE GAZA STRIP.

PREPARED FOR:

INITIATIVE FOR SUSTAINABLE AND ACCESSIBLE MICROFINANCE INDUSTRY.
(ISAMI)

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April 27, 2002

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1). EXECUTIVE SUMMARY.

1.1). As required by the Scope of Work (SOW), the consultant spent twenty four days in East Jerusalem and Amman, Jordan, preparing a feasibility study for the establishment of an independent microfinance subsidiary in the West Bank and the Gaza Strip (WBGS). The main findings of this study are as follows:

1. While the conclusion of this survey is that there is a compelling case for the establishment of an independent microfinance subsidiary; it is not advisable to establish such an entity until the current political crisis is satisfactorily resolved. Furthermore, there must be a reasonable expectation that there will be economic and political stability over the medium term before proceeding. This study, therefore, presupposes that no action will be taken until normalcy returns. Consequently, the study is based on an economy that is operating under peacetime conditions, and that the economy will recover rapidly to the pre Second Intifada levels of activity when the situation returns to normal.

2. At the present time, the prevailing legal system in WBGS is not conducive to lending activities, a fact that is well recognized. The various steps that need to be taken to rectify this situation have been identified, and include ratification of the "Basic Law" and "The Independence of the Judiciary Law". The basic infrastructure for the functioning of a commercial law code also needs to be established. Under these circumstances, it is not recommended that a new microfinance provider enter the WBGS microfinance market until these issues have been resolved. An existing lender who is familiar and comfortable with these problems, however, may elect to proceed with the establishment of a subsidiary, despite these shortcomings; after the political and security outlook becomes clearer.

3. The study recommends that any proposed subsidiary use the individual loan methodology, as it is the most appropriate methodology for the projected target market. Furthermore, that the subsidiary extend loans to registered Small and Micro Entrepreneurs (SMEs) only, within a loan size range of US$1,500- US$ 15,000. The maturity of the loans offered should vary between twelve and thirty six months. Within this designated target market, there appears to be a shortfall between the supply of, and the demand for, credit of approximately US$ 51,000,000. This suggests that there is sufficient demand to justify an existing lender forming an independent subsidiary to further service this market, or for a new entrant to enter the market, after normalcy has returned.

4. There are considerable advantages to forming an independent microfinance subsidiary, which far outweigh the advantages of integrating such operations into normal banking activities. These include strategic advantages regarding market focus, the need for unique marketing strategies and different regulatory requirements, while operational advantages encompass a simplified management structure, the need for different credit criteria, specialized training, specific MIS needs, and the importance of separation of duties and responsibilities. The financial management advantages include the need for specialized staff bonus schemes, and having to clearly allocate costs. The psychological advantages relate to better acceptance of the activity by both the market and the Palestinian Authority.

5. The establishment of an independent subsidiary also will be extremely profitable for the parent commercial bank. The microfinance activities of the subsidiary itself basically break-even in year three of operations. In years four and five the return on average assets is projected to be 0.84% and 1.88% respectively, while the return on

average equity is projected at 48.3% and 73.0% respectively. In addition, the parent bank will generate substantial earnings from the loan spread on loans made by it to the subsidiary, so that the latter can fund its loan portfolio. These earnings are projected to rise from US$ 55,000 in year two to US$ 353,000 in year five. Sensitivity analysis indicates that even under several negative scenarios, the venture still remains strongly profitable.

6. Several risks relating uniquely to the establishment of an independent microfinance subsidiary have been identified, the most important of which is regulatory risk. This risk arises due to the lack of any clear regulations for the oversight of the subsidiary, and the possibility that they may turn out to be unduly onerous. This risk can be managed, however by taking a proactive approach with the Palestine Monetary Authority, and proposing to them guidelines that balance the need for prudential oversight with the needed operating flexibility for the lenders.

7. For the establishment of an independent subsidiary to be successful, however, there are a number of critical success factors that will need to be adhered to. The most important of these are the appointment of a strong, dynamic leader of the subsidiary, whom the parent commercial bank is prepared to strongly support. Understanding the need for allowing the subsidiary to adopt a more risk taking culture, permitting it to select its own clients and staff, and to prepare its own credit and policies, procedures and practices manuals are also extremely important. Finally, the subsidiary will need to be adequately capitalized, and be given a reasonable time period to prove the viability or otherwise of the concept, if the venture is to stand a reasonable chance of success.

8. Finally, the study outlines an action plan for the establishment of a subsidiary by a commercial bank. This plan envisages a time span of approximately nine months for the creation, registration, funding, creating the necessary logistical infrastructure, and staff recruitment and training, before the first loan will be disbursed. Within this action plan, a specific final decision point for continuing with the concept, or canceling it, is set in month 5. If the decision at this stage is to proceed, the senior management of the parent commercial bank must be prepared to give the subsidiary every opportunity to prove the success of the concept.

9. The success of the subsidiary depends heavily on the productivity of the field agents, and the ability to leverage-off the fixed costs inherent in microfinance. Senior management will have to pay close attention to productivity, if the benefits of this strategy are to be maximized.

2). ACRONYMS USED IN THIS REPORT.

AMC	Al Ahli Microfinancing Company
ED	Executive Director
EU	European Union
FTE	Full Time Employee
FY	Financial Year
GDP	Gross Domestic Product
HO	Head Office
IFC	International Finance Corporation
IMF	International Monetary Fund
ISAMI	Initiative for Sustainable and Accessible Microfinance Industry
IT	Information Technology
JD	Jordanian Dinar
JNB	Jordan National Bank
LLC	Limited Liability Company
MOET	Ministry of Economics and Trade
MFI	Microfinance Institution
NGO	Non Governmental Organization
NIS	New Israeli Shekel
p.a.	Per Annum
PA	The Palestinian Authority
PMA	The Palestinian Monetary Authority
ROA	Return on Assets
ROE	Return on Equity
SME	Small and Micro Entrepreneurs
SOW	Scope of Work
UNRWA	United Nations Refugee and Works Agency
USAID	United States Agency for International Development
US$	United States Dollars
WBGS	West Bank Gaza Strip.

3). INTRODUCTION AND SCOPE OF WORK:

General:

3.1). In Accordance with the contract with Chemonics International, Inc. dated March 15, 2002; the Consultant spent 25 working days during the period March 31- April 28, 2002 in the West Bank and Gaza Strip (WBGS), and Jordan, completing this assignment. The Scope of Work (SOW) was predicated on the recognition that when considering entering into microfinance activities, a commercial bank has the option of either establishing an independent specialist subsidiary, or of integrating microfinance services into its normal banking operations. Hence, the aim of the assignment was to prepare a study of the feasibility of establishing a specialist microfinance subsidiary by a commercial bank, which would provide microfinance services in WBGS. The feasibility study would:

(i). Assess the viability of establishing such a subsidiary

(ii). Prepare financial forecasts under various scenarios displaying the likely financial results of establishing such a subsidiary.

(iii). Outline the steps necessary for the establishment of a separate subsidiary.

3.2). This report consists of an executive summary, a detailed report and projections. At the end of relevant sections, there is a brief summary of the conclusions and findings of those sections. Additionally, a key section of the report outlines the necessary conditions precedent that will have to be in place for such a venture to be viewed as viable by a commercial bank.

Definition of Micro or Small Scale Enterprises Activities and of Microfinance:

3.3). For the purposes of this report, the definition or micro or small-scale enterprises (MSEs) will be enterprises that employ ten or less individuals, on either a remunerated or an unremunerated basis. Microfinance is defined to be the provision of a broad range of financial services to these businesses[1], such as depository services, loans, and funds transfers.

Basic Assumptions:

3.4). This report is based on certain assumptions regarding the lending methodology and loan size policies that commercial banks will adopt when approaching the MSE market. Firstly, banks will adopt the individual loan methodology, as opposed to the group or village bank methodologies. Secondly, that the minimum loan amount extended to clients would be US$1,500[2], while the maximum loan amount will be US$ 15,000. Loans in excess of this latter figure would be serviced by the regular loan facilities of commercial banks. Thirdly, if necessary, the subsidiary would be prepared to offer loans on both an interest cost basis and on an Islamic banking principles basis.

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[1] This definition complies with the one used in the report "Analysis of the Policies, Laws, Regulations and Supervision Practices Affecting the Environment for Microfinance in WBGS", S. Charitonenko, February 2001.

[2] The demand for loans under this limit will be serviced by FATEN and UNRWA.

4). THE CURRENT BANKING/MICROFINANCE ENVIRONMENT IN THE WEST BANK GAZA STRIP.

Recent Economic Performance:

4.1). Since the establishment of the Oslo peace accords in 1993, the performance of the WBGS economy showed steady improvement up to, and including, 1999. This trend is demonstrated through the following statistics, which are the most current available.

Summary of Key Economic Data[3]

(In US$)

Indicator	1995	1996	1997	1998	1999	2000
GDP*	3,504	3,878	4,182	4,464	4,954	4,579
GDP Per Capita Income	1,411	1,474	1,502	1,541	1,641	1,485
Consumer Inflation %	10.8	8.4	7.6	5.6	5.5	2.8
Unemployment Rate %	18.2	23.8	20.3	14.4	11.8	14.1
Budget Surplus/Deficit*	(224)	(243)	(466)	(440)	(293)	(400)
Current Account Balance*	(1,936)	(2,405)	(2,436)	(2,623)	(2,767)	(2,933)
Donor Financing*	665	795	735	716	549	

*In millions of US Dollars.

4.2). During this 1993 –1999 period, the WBGS enjoyed moderate to strong growth, with the per capita income indicating that the economic growth consistently outpaced the growth in the population. Simultaneously, inflation was progressively reduced over the period, falling to an impressive 2.8% in 2000. In parallel with these achievements, the operating budget deficit was kept within a range so that it was more than funded by the donations and grant flows over the period. Of equal importance, the economy was able to generate sufficient jobs, not only to provide employment to new high school graduates, but also to reduce the overall unemployment level to 11.8% in 1999. The only major macroeconomic shortcoming during this period was the inability to reduce the current account deficit. This deficit increased fairly steadily over the period, and remains at a very high percentage when measured against the Gross Domestic Product (GDP). This imbalance reflects the heavy reliance of the WBGS economy on imports. It is, however, partially offset by the large inflow of donor funds into the economy.

4.3). With the commencement of the second Intifada on September 28, 2000, however, the economy went into a sharp decline, with GDP falling, and unemployment increasing to 14.1% of the workforce. In 2001, economic activity declined even further as the political situation continued to deteriorate. It is unrealistic to assume that economic growth will return until there is a mutually acceptable resolution of the causes of the problems.

4.4). Despite the recent setbacks, the performance of the WBGS economy during times of political/ social normalcy, and when the global economy is growing, indicates that it is capable of performing well given the opportunity to do so. The Palestinian Authority (PA) and the Palestinian Monetary Authority (PMA) have shown that they can provide the necessary conditions of positive and stable economic growth, low inflation, and a balanced budget (after donor funds) to enable the economy to perform well. This is despite having the relative

[3] Sources: World Bank, IMF reports, and the Palestine Central Bureau of Statistics..

disadvantage of not being able to use monetary levers to manage the economy[4]. In some regards, this lack of a monetary policy could be considered a positive, since it cannot be driven by political considerations. At this time, however, it is not anticipated that a unique WBGS currency will be introduced within the near future.

4.5). Based on their historical performance, therefore, it is reasonable to assume that when conditions of normalcy return, the PA/PMA again will be able to provide a stable economic environment that will encourage further growth in the economy.

The Current Socio-Political Environment:

4.6). Since the beginning of the second Intifada in September, 2000 there has been a progressive deterioration in the socio-political environment in WBGS, and to a lesser extent, in Israel proper. Unsurprisingly, business activity has contracted, and the private sector in general has become extremely cautious in planning for the future.

4.7). The increased level of caution impacts the commercial banking sector on two levels. Firstly, as business activity declines, the underlying demand for loans contracts, resulting in reduced loan portfolios for the banks. Secondly, the commercial banks, in order to protect their own positions, must, and do, become more cautious about extending loans, due to the uncertainty of the business environment. Commercial banks can only be expected to extend loans when they are able to plan on a stable political/socio/ economic environment over the medium term.

4.8). Given the current situation prevailing in WBGS, it is unrealistic to expect that commercial banks will consider expanding operations until a political settlement is agreed and implemented. Moreover, should the existing conditions deteriorate even further, the banks could be obliged to further restrict their activities. Hence, the establishment of an independent subsidiary of a commercial bank to undertake microfinance activities should only be considered when a long-term solution to the current political/social unrest has been agreed and implemented. Consequently, it is not expected that this report will be acted on until such conditions are achieved.

Conclusions Regarding the Banking Environment in the West Bank Gaza Strip:

1). During a period of relative normalcy, the economy of WBGS performed relatively well, suggesting that given the right circumstances, the PA/PMA can provide an economic environment conducive to business activities. This is despite their lack of fiscal tools with which to manage the local economy.

2). Since the commencement of the second Intifada in September 2000; the economic environment in the WBGS has deteriorated markedly, and is not likely to recover until a mutually agreed upon resolution of this conflict is implemented.

3). Given the prevailing political/ social crisis it is unrealistic to expect a commercial lender to expand their lending activities until such a settlement is reached. Thus, this report is predicated on the assumption that its recommendations would be implemented after a settlement has been implemented, so that the parent commercial bank can plan over the medium term with a certain degree of confidence.

[4] WBGS does not issue its own currency. Under the current policy, the United States Dollar (US$), the Jordanian Dinar (JD), and the New Israeli Shekel (NIS) all circulate freely.

5). AN OVERVIEW OF DEMAND FOR MICROFINANCIAL SERVICES IN THE WEST BANK AND THE GAZA STRIP.

5.1). During the preceding five years, several surveys of the potential demand for microfinance services have been undertaken[5]. The most recent of these is the study undertaken by Masser Associates, whose first draft was submitted in November 2001 (The Masser Survey).

5.2). All of these reports, however, exclude the impact the second Intifada has had on the level of business activity; the earlier reports due to their timing, and the Masser Survey due to design. The Masser survey noted that since September 2000, there has been a dramatic fall in the level of business activity in WBGS, with capacity utilization currently running at less than 50%. Furthermore, 94% of the participants in the survey reported an average decline in business activity of approximately 40%. The following discussion and projection of the potential market demand for microfinance products, therefore, is predicated on a return to a *normal operating environment*, and not on the currently prevailing situation in WBGS. As noted earlier, this report does not anticipate that a commercial bank will undertake new or incremental lending activities until the situation returns to normal.

5.3). The Masser Survey quantified the projected number of micro and small entrepreneurs (MSEs) employing ten or less people in the WBGS to be approximately 69,400[6] in normal circumstances. The activities of these borrowers were heavily weighted towards trading activities (58%), manufacturing (20%) and services (12%). The survey further indicates that 41% of these businesses would be interested in borrowing on an interest charged basis, and a further 15% said that they would be prepared to borrow under an Islamic banking system[7]. Of these potential borrowers, about 72% expressed interest in borrowing amounts within a range of US$1,500-US$15,500. This would result in a potential "pool" of 28,000 clients (69,400*56%*72%).

5.4). The Masser Survey then projects that there are three potential scenarios for loan demand.

- Scenario one assumes that 80% of potential borrowers are eligible and qualified. The probability of this occurrence is 50%.
- Scenario two assumes that 50% of potential borrowers are eligible and qualified. This probability is 30%
- Scenario three assumes that 20% of potential borrowers are eligible and qualified. This probability is 20%.

5.5). The weighted average of these scenarios results in a projected demand of approximately 16,500[8] creditworthy clients who are willing to use credit to finance their business activities. Using the Masser Survey's estimated weighted average loan size within the US$1,500-US$15,000 niche of US$6,550[9], the market demand of this niche could approximate US$108,000,000. This projection is less than estimated demand posited by a prominent local

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[5] These include studies by Weidemann Associates (October, 1999), Masser Associates (May 1998 and November 2001) and an International Finance Corporation survey.

[6] This number is based on the number of businesses registered with the Palestinian Central Bureau of Statistics, plus a 3% per annum projected growth rate to allow for the inbuilt lag time in government statistics.

[7] This estimate roughly coincides with a UNRWA estimate undertaken in 2000 that approximately 50% of SMEs were interested in loan capital. Report by S. Cherentonenko, p.14.

[8] (28,000*80%*50%=11,220)+(28,000*50%*30%=4,200)=(28,000*20%*20%=1,120)=16,520.

[9] This is based on the weighted average of loan size requested within the targeted loan amount range as quantified in p.24 of the Masser Report. This amount was then discounted by 10%.

banker[10], who placed the potential demand for microfinance loans for amounts larger than US$1,500 at about US$140-150 million. This lower amount of US$ 108 million, though, is used for the purposes of this study.

5.6). If a subsidiary company can achieve a market penetration level of approximately 20%, its potential loan portfolio target market of clients within the US$1,500-US$15,000 is 3,300 clients. This would translate into a loan portfolio outstanding of about $22,000,000[11]

5.7). The Masser survey indicates that 25% of the borrowers would be seeking inventory loans, while another 28% were looking for short- term working capital loans. In total more than half of the loan demand would be for short- term facilities, possibly of a revolving nature. Twenty nine per cent of the participants also requested loans for recognizable capital expenditures, indicating that there is a genuine need for a medium to long- term loan product.

5.8). Given the small land area of WBGS, the geographic spread of this market would be limited. Weidemann Associates[12] estimated that 62% of all of the registered enterprises were located in Jenin, Nablus, Ramallah, Hebron and Gaza. Consequently, a majority of the total demand could be serviced from relatively few portals.

5.9). In addition to the formal, registered MSE's, there is a large sector of informal businesses, often operated out of personal residences rather than from formal business premises. Masser Associates estimated this market could include 15%-25% of the total number of households in WBGS, or 40,000-50,000 informal businesses[13]. The great majority of these businesses, however, will require loans within the range of US$ 500-1,500, which probably is too small for the purposes of achieving profitability using the individual loan methodology. Consequently, it is assumed that this market will be better served by MFIs such as FATEN and UNRWA than by a commercial finance lender. Consequently, these potential borrowers have been excluded from the calculation of potential demand.

[10] Meeting 4/1/2002.
[11] $6,550*3,400=$21,600,000.
[12] Assessment Report of the Demand for Microenterprise Finance and Demand Elasticity Factors in WBGS, Weidemann Associates, 10/13/1999.
[13] Telephone conversations with Mazen As'sad of Massar Associates, 4/7/02 and 4/23/02.

6). AN OVERVIEW OF THE MICROFINANCE PROVIDERS IN THE WEST BANK AND GAZA STRIP.

6.1). The provision of microfinance services appears to be a relatively recent phenomenon in WBGS. Traditionally the commercial banks have lent against collateral rather than cash flow, usually requiring either strong personal guarantees, or land with clear title. These requirements essentially excluded SMEs from access to commercial loans. The first microfinance assessment undertaken in 1996[14] indicated that the overwhelming source of funding available to microentrepreneurs was from personal savings, remittances and family loans. By 1999, however, 22 banks had opened 106 branches in WBGS, and several of the major banks had started microfnance programs under the auspices of USAID, and the International Finance Corporation (IFC). Several Non Governmental Organizations (NGOs) also had started microfinance activities at this time. The Weidemann Associates survey estimated that as of June 1999, the potential supply of microfinance was about US$ 78 million, of which US$57 million was provided through the commercial banking sector, and US$ 21 million through NGOs and UNRWA.

6.2). The funding provided through the commercial banks is provided from their own resources and through an IFC program (Arab Bank, Commercial Bank of Palestine and Jordan National Bank). Drawing from the Massar Survey, and data supplied by IFC, the estimated current level of funding available and loans outstanding are as follows:

SOURCE	US$ AVAILABLE	No. OF BORROWERS	BALANCE
Bank of Jordan	2,000,000	661	861,000
Bank of Palestine	1,500,000	558	600,000
Jordan National Bank	8,000,000	373	2,327,000
Commercial Bank of Palestine	5,000,000	122	544,000
Arab Bank	10,000,000	125	715,000
Palestine Banking Corporation	12,000,000	600	2,500,000
Bank Total	38,500,000	2,439	7,547,000
FATEN	3,000,000	5,466	1,900,000
YMCA	4,500,000	500	4,000,000
ASALA	1,000,000	576	914,000
ANERA-Arab Bank	5,000,000	566	1,030,000
CARE	65,000	69	40,000
UNRWA	12,700,000	9,450	5,800,000
PARC	1,500,000	300	900,000
ACAD	500,000	312	900,000
Total NGOs	28,265,000	17,239	15,484,000
Combined Total	66,765,000	19,678	23,031,000

6.3). The above table indicates that of the total amount available for microfinance loans has fallen from approximately US$ 78 million in 1999 to about US$ 67 million currently. Therefore, there is a potential demand/supply imbalance of at least US$ 116,000,000[15] for the entire projected market demand by legally registered SMEs.

6.4). Within the projected market niche proposed for the subsidiary, US$1,500-US$ 15,000, the subsidiary would face competition from all of the above lenders except FATEN and CARE, both

[14] Microfinance Sector Assessment of the WBGS; Silcox, Jensen and Kula, February 1996.
[15] 69,400*56%*$6,550=183 million-67 million=116 million.

of whom specialize in smaller loans. UNRWA lends to both the tier below the projected market niche, as well as within the niche itself.

6.5). Assuming that UNRWA commits 50%[16] of its available funding in the proposed market niche, and conservatively assuming that the other lenders committed all of their available funding to this niche, the total funding available would US$ 57 million. This would leave a potential funding gap within the target niche of about $51 million.

6.6). The above estimates indicate that there is likely to be a shortfall in available funding for the designated market niche after the political- security situation returns to normal. This gap will not be filled by the traditional sources of informal funding, such as savings or family loans, since living costs incurred during the Intifada, and subsequent rebuilding costs will have heavily depleted these sources. Therefore, there is an opportunity either for an existing commercial lender to expand their activities using an independent, microfinance subsidiary, or for an additional lender to commence servicing this market niche.

Conclusions Regarding the Balance Between Supply and Demand for Microfinance Services.

(i). The demand for microfinance services will come from both the formal and the informal sectors of the Palestinian economy. The most recent available figures suggest that there are about 69,000 registered SMEs and 40,000-50,000 informal SMEs operating in the WBGS during normal times.

(ii). Within the designated market niche for the proposed subsidiary, of loans within the range of US$1,500-US$ 15,000 to registered SMEs; the estimated demand could be in the realm of US$108,000,000. This demand consists of about 16,500 loans of an average loan size of US$ 6,550.

(iii). The current supply of loan funds for this market niche is estimated to be approximately US$57,000,000, leaving a funding gap of about US$51,000,000.

(iv). This funding gap indicates that there is sufficient demand within the designated market niche for an existing microfinance lender to further expand its activities using an independent subsidiary. Alternatively, there is sufficient surplus demand to support the entry of a new microfinance provider into the market niche, using a specialized microfinance subsidiary.

[16] This allows for UNRWA's lending to the informal sector, which is not considered part of the subsidiary's target market.

7). THE HISTORICAL PERFORMANCE OF MICROFINANCE IN THE WEST BANK AND THE GAZA STRIP.

7.1). Microfinance in the WBGS traces its antecedents back to a program started by the Save the Children Federation in 1986. This program continued in its then current form until 1992, when the group- lending concept was introduced. FATEN, the successor to Save the Children, was formed in July, 1998 and commenced operational activities in March, 1999.

7.2). Since then, microfinance activity has grown rapidly, with the loan portfolio outstanding as of late 2001 was US$67,000,000, consisting of about 20,000 borrowers[17].

7.3). Currently, microfinance is provided by fourteen institutions, of which seven are Non Governmental Organizations (NGOs) and six are commercial lenders. Additionally a United Nations Agency, UNRWA extends loans to SMEs.

7.4). Prior to the start of the second Intifada in September 2000; the microfinance providers had uniformly enjoyed a high loan repayment rate of 96.2%. This high rate was uniform across both the commercial banks (96.3%) and NGOs/UNRWA (95.8%)[18]. For the large majority, however, the repayment rate was closer to 99%, since three lenders had loan repayment rates of 60%, 75%% and 85.5% respectively, thereby dragging down the overall average. This performance compares favorably with the performance of the commercial banking sector, where the average loan repayment rate was within the 90%-95% range[19].

7.5). Since the start of the second Intifada, however, the loan repayment rate has deteriorated in line with the general economy. And the SME sector has been more negatively impacted than the economy in general. The Massar Survey reveals that the loan repayment rate deteriorated for most lenders, with the loan repayment rate varying between 50% (the UNRWA Small Scale Entrepreneurs program) to 98% repayment rate for the Palestinian Banking Corporation and 100% repayment rate for CARE. The loan repayment rates of the commercial bank microfinance portfolios has stood up rather well, though, with Arab Bank achieving a 75% repayment rate, Bank of Jordan 78%, Bank of Palestine 92% and Commercial Bank of Palestine 92%. These figures are comparable with the loan repayment rate for the overall commercial banking sector of about 80%.

7.6). These statistics confirm that the credit risk of lending to the SME sector is comparable to that of the commercial banks overall private sector loan portfolio.

Conclusions Regarding the Historical Performance of Microfinance in the WBGS:

i). The loan repayment rate prior to the start of the second Intifada for the large majority of SME lenders was 99%, which was superior to the industry wide average of 90%-95%.

ii). Since the start of the second Intifada, the loan repayment rates have fallen across the entire financial sector. The microfinance loans extended by commercial banks performed well in

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[17] In terms of borrowers, FATEN had the largest market share with about 9,500 borrowers

[18] “Assessment Report of the Demand for Microenterprise Finance and Demand Elasticity Factors in WBGS”, Weidemann Associates, 10/13/99, p. IV-7.

[19] This figure is based on several interviews, rather than on hard data due to the PMA treating the information as confidential. Furthermore, it excludes loans to the Palestinian public sector.

comparison with general private sector repayment rates, though, with repayment rates ranging from 75% to 98%, as compared to the sector average of 80%-85%.

iii). This historical performance indicates that, correctly structured, loans to SMEs carry a comparable to slightly lower risk of default than the overall private sector industry average.

8). ADVANTAGES OF THE INTEGRATED APPROACH TO PROVIDING MICROFINANCE SERVICES.

8.1). As noted in the Introduction section, there are two approaches available to a commercial bank when considering entry into the microfinance marketplace. These are to fully integrate microfinance services into the daily operations of the bank, or to establish an independent microfinance subsidiary.

8.2). The identified advantages of fully integrating microfinance activities into regular bank procedures are as follows:

(i). Microfinance Services are Treated as Standard Banking Products:

8.3). By providing microfinance services through the normal service delivery channels of the bank, microfinance is fully integrated into the normal banking services of the staff, thereby "mainstreaming" microfinance into the banks' activities. This approach fully entrenches microfinance as a regular banking activity, thereby creating greater strategic commitment to the concept of servicing the SME market.

(ii). Since the Staff at the Branch Level Earn Income From Microfinance Activities, There is a Higher Degree of Commitment by Them to Its Success.

8.4). Most commercial banks manage their branches as individual profit centers. This focuses the attention of both the management and staff of the branch on activities that make the most profit for the branch. If the microfinance market is managed as an income generating activity of the branch, so that its success will result in financial bonuses for branch management and staff, the staff will be more committed to the concept than otherwise would be the case.

(iii). Using the Existing Branch Structure Will Permit a More Rapid Implementation.

8.5). The use of existing staff and logistical outreach of the commercial bank will permit a more rapid implementation of the program than will establishing a stand-alone office. Using an existing branch structure obviates the necessity of locating and equipping an office, the hiring and training of new staff, preparing a new MIS system and writing entirely new Procedures Manuals.

9.1). THE ADVANTAGES OF ESTABLISHING AN INDEPENDENT MICROFINANCE SUBSIDIARY.

9.1). There are clear advantages to establishing an independent microfinance subsidiary, rather than using an existing branch system. These advantages can be classified as being strategic, financial management, operational and psychological; and include the following:

Strategic Advantages:

Clear Focus on One Market and on Specific Financial Products:

9.2). A specialized subsidiary will have a clear focus on a specific target market, and on providing specialized financial products to that market. If the SME market is included as one of a number of market niches that a loan officer, or a branch, is required to service, the specialized knowledge needed to successfully exploit the SME market will be dissipated.

Different Marketing Strategies.

9.3). The marketing strategies employed by microfinance lenders and commercial bank lenders are quite different. The marketing strategy for the microfinance market is extremely proactive, requiring the field agents to physically be out in the market place, soliciting current and potential clients. Commercial bankers, on the other hand, tend to deal with clients within the bank branch itself, rather than at the clients' premises. This different approach to marketing will cause friction amongst the staff, if the microfinance field agents are working alongside the regular commercial loan officers.

Legal and Regulatory Oversight:

9.4). As noted in the section dealing with legal and regulatory issues[20], the level and intensity of legal and regulatory oversight for microfinance activities has not, as yet, been clearly established. It does appear, however, that the regulation of "specialized lending institutions" will be less rigorous than that imposed on commercial banks. This will give the subsidiary greater latitude in expanding their lending activities than otherwise would be the case. Furthermore, since the regulations have not been drafted at this time, the parent commercial bank would have the singular opportunity of proposing to the PMA some suggested guidelines for these regulations. Finally, the use of a subsidiary might provide the parent commercial bank with additional flexibility regarding compliance with the loan to deposit ratio, and the foreign asset ratio requirements of the PMA.

Operational Advantages:

Simplified Management Structure And Shorter Chain Of Command:

9.5). A critical component of a successful MFI is its ability to expedite the approval and disbursement of loans. This requires a flatter and more flexible management structure than normally found in commercial banks. The use of the standard banking/ commercial branch structure will not achieve the required speed of response needed for successful microfinancial activities. Similarly, the imposition of a separate MFI management structure within, or alongside, the standard banking management hierarchy will only cause confusion.

[20] "Legal Issues Regarding the Establishment of an Independent Microfinance Subsidiary".

Different Credit Criteria:

9.6). One of the major differences between microfinance and commercial lending is the lack of emphasis placed on collateral. Microfinance is mainly cash flow lending. This necessitates a different set of analytical skills from those used to analyze regular lending activities. If the two types of credit analysis are inter-mixed, it will confuse both the loan officers/field agents and the credit specialists.

The Need for Specialized Training for Microfinance Lending.

9.7). Given the different requirements of microfinance lending, compared to commercial lending, there is a clear need for specialized microfinance training[21]. Furthermore, there needs to be ongoing continuing education program for this training to be effective. Since attending training courses is seen by many as a "special fringe benefit", this continual training regimen could be a source of friction with other branch staff members. Moreover, it is more cost effective to provide the training to all field agents on-site in one location, rather than having them travel to an off-site location.

The Need for Tailored MIS Systems:

9.8). The design and operation of an effective MIS system is a major challenge for most commercial banks. Difficult as this is, the design and operation of MIS systems is even more challenging for microfinance lenders, given the more detailed level of information that must be tracked. Consequently, efforts to integrate (or adapt) standard commercial bank loan tracking systems have been less than successful. While the design and installation of specialized loan tracking for MFIs is fraught with problems, it is preferable to integrating the microfinancing portfolio into an existing commercial loan portfolio's MIS system. This need for separation of the loan portfolios further supports the benefits of establishing a stand-alone subsidiary.

The Different Approach to Loan Monitoring:

9.9). With the lesser emphasis placed on collateral, the need to carefully monitor the client's financial performance is of paramount importance to the success of a microfinance program. This need to remain in close contact with the client after the loan has been disbursed is quite different to the commercial banking approach, whereby the loan officer may meet with the client only once a year. Having these two different approaches operating simultaneously out of the same branch will cause disruption in the management of the branch itself, as well as creating friction between the staff.

The Need For A Clear Separation Of Duties:

9.10). Microfinance is at its most effective when undertaken as a specialist activity. If loan officers in the various branches are designated as microfinance specialists, but report to the branch manager, there is a high probability that the microfinance specialist will be assigned general branch duties in addition to, or instead of, their specific assignment. This will weaken the focus on the SME market.

Removal From Intrabank Pressures Regarding Credit Decisions

9.11). A specialized stand-alone subsidiary, with its own management structure and credit guidelines, will be better able to resist pressure from bank senior staff to make loans to favored clients, or friends of bank employees.

[21] For example, the Institute of Banking Studies in Jordan hosts a specific training program for microfinance lenders.

The Need To Operate Outside Standard Banking Hours:

9.12). With its focus on specialized services, the staff of MFIs need to work irregular hours, often dealing with clients outside of the client's normal business hours. This needed flexibility is at odds with the normal banking hours of 8.30-12.30 for dealing with clients, and 8.30-14.30 for bank employees. Hence, if the microfinance staff are based in existing bank branches, their ability to interact with their clients will be severely constricted, unless the branch is prepared to incur the additional costs of keeping the branch open for longer hours.

Financial Management Advantages:

The Importance of Performance Motivation Schemes:

9.13). Even more than is the case with standard commercial bank lending, productivity is key to the long-term success of a microfinance program. Best practices indicate that one of the most effective ways to achieve this is by the establishment of a bonus incentive system for field agents. This incentive system, however, could be at odds with the remuneration package paid to the other employees of the commercial bank, and therefore cause friction amongst branch staff. This argues for locating the staff working on microfinance activities separately from the regular commercial bank staff.

The Need for Clear Performance Measurement Capacity:

9.14). Commercial banks should enter into microfinance activities only if it will be a profitable activity. If it is unprofitable, the program cannot expect to be sustainable over the medium to long term. Thus, it is important that the parent commercial bank has the capacity to monitor and measure the financial performance of the microfinance activity.

9.15). Under the fully integrated approach, the individual costing of the microfinance program will be difficult. This is due to the need to allocate overhead costs, and to separate out at the branch level the various loans being booked through the branch. This problem argues for the establishment of a separate, stand-alone subsidiary that will be its own profit center.

Psychological Advantages:

Clear Individual Identity as a Microfinance Services Provider:

9.16). The establishment of a separate entity, preferably using a specialized name, will enable the program to establish an individual entity as a microfinance provider, with a specialized focus on SMEs. This will help the program avoid association with the sometimes poor reputation banks have amongst many SMEs.

The Advantage of Being a Registered Palestinian Company.

9.17). Many Palestinians will prefer to develop a relationship with a microfinance provider that is viewed as a Palestinian entity, rather than as a branch of a foreign bank. Furthermore, the establishment of a locally registered company undertaking microfinance activities likely will be welcomed more enthusiastically by the PA, than would an existing foreign bank expanding its operations into microfinance.

Conclusions Regarding the Advantages of Establishing an Independent Microfinance Subsidiary, as Compared to Adopting an Integrated Approach:

(i). There are considerable non-financial advantages to establishing an independent microfinance subsidiary, rather than adopting an integrated approach. These advantages can be categorized as strategic, operational, financial management and psychological. They include the following: clearer market focus, a better ability to adopt a specific marketing strategy, likely less stringent regulatory oversight, the importance of a simplified management structure, the need for different credit criteria, easier implementation of specialized staff training and the establishment of a tailored MIS system. The need for a specialized performance motivation scheme, separate financial tracking, the requirement to better match clients' business hours, and the psychological advantages of being viewed as a Palestinian non-bank all argue for the establishment of a separate microfinance subsidiary. These advantages considerably outweigh the advantages of adopting an integrated approach, which are a more rapid implementation, better co-operation by existing branch staff and the more complete integration of microfinance into the regular activities of the bank.

10). THE CRITICAL SUCCESS FACTORS IN ESTABLISHING AN INDEPENDENT MICROFINANCE SUBSIDIARY.

10.1). Based on previous experience, there are certain critical success factors[22] that an independent microfinance subsidiary needs to adhere to, in order to be successful. The most important of these factors are as follows:

Strong Support for the Concept from the Senior Management of the Parent Bank.

10.2). The senior management responsible for oversight of the subsidiary must be strongly committed to both the success, and independence, of the subsidiary. Senior management must be prepared to act forcefully to protect the subsidiary from external meddling by other senior bank staffers.

The Culture of the Subsidiary:

10.3). Banking is about taking risk. Microfinance is about managing a higher level of risk and offsetting this with a higher level of reward. The parent bank must understand that a risk averse strategy is inappropriate if the microfinance subsidiary is to be successful. Consequently, the parent company must tolerate more of a risk-taking culture in the subsidiary than is encouraged in the parent company.

The Need for Dynamic Leadership in the Subsidiary:

10.4). Successful MFIs have adopted aggressive marketing and outreach strategies towards their target markets, as well as being flexible regarding the provision of financial products. To ensure that the subsidiary has these necessary ingredients for success, the senior management of the Bank must install a dynamic individual as the Managing Director of the subsidiary.

The Need to Provide both Standard and Islamic Banking Products:

10.5). In order to fully capitalize on SME market niche, the subsidiary must be willing to provide both standard and Islamic banking products. It is estimated that the potential demand for standard banking products would be approximately 12,000 clients, while potential Islamic banking clients increase the total potential clients to 16,500.

The Importance of Correctly Costing the Subsidiary's Loan Products:

10.6). The proposed loan products of the subsidiary need to be correctly costed on a "fully loaded" basis, to ensure that all products will be net income generators.

The Recognition of the Differences Between the SME Market and the Commercial Loan Market:

10.7). The parent commercial bank must be cognizant of the fact that the SME market has certain distinctive traits that will require adopting different risk management and marketing strategies. The parent company must be prepared to devolve sufficient responsibility and accountability to the subsidiary, so that it can manage these strategies according to the needs of its marketplace.

[22] This section draws heavily on the experience of independent subsidiaries of commercial banks in South Africa, Mozambique and Jordan.

The Importance of Establishing a Clear Career Path for the Staff:

10.8). It is highly likely that during the initial stages at least, the senior management positions of the subsidiary will be filled by staff seconded from the parent commercial bank. If this is the case, the parent commercial bank must ensure that the secondment to the subsidiary is not considered by the staff involved as being prejudicial to their future careers with the parent. If this cannot be assured, it will be difficult to get high quality staff to accept a secondment to the subsidiary.

The Need to Adequately Capitalize the Subsidiary:

10.9). The parent commercial bank must adequately capitalize the subsidiary, so that it does not become too heavily reliant on debt capital. The level of capitalization should be sufficient to finance at least the first 18 months of the subsidiary's activities.

The Importance of a Medium Term Perspective:

10.10). It is extremely important that the parent commercial bank's expectations of the subsidiary for reaching the break-even point are realistic. Pressuring the subsidiary to rapidly grow its loan portfolio will result in loan quality problems, and eventually large loan losses. Equally importantly, the subsidiary needs to be given a reasonable time frame in which to prove itself.

Devolve the Establishment of the Subsidiary's Policies, Procedures and Practices to the Subsidiary.

10.11). While the policies, procedures and practices of the parent commercial bank may be used as a guide, the subsidiary must be allowed to draw up its own guidelines for what is, essentially, a different market.

The Importance of the Subsidiary Having the Authority to Select its Own Clients and Staff:

10.12). The subsidiary must have complete discretion in the hiring of its own staff, and in approving the extension of loans to clients. If departments of the parent commercial bank are permitted to transfer either, or both, poor performing clients and/or staff to the subsidiary as a way of solving their own problems; the subsidiary will face an uphill task in achieving its pre-determined goals.

The Importance of Establishing a Good Working Relationship with the Branch Network:

10.13). With the subsidiary requiring that all of its clients open an account with a branch of the parent bank that will be used for disbursing and repaying the loan, it is important that the subsidiary develops a good working relationship with the managers of the various branches. The attitude taken towards the clients of the subsidiary by branch staff could be a critical factor as to whether those clients decide to take repeat loans from the subsidiary. To encourage the branches to adopt a professional attitude towards their clients, it may be necessary for the subsidiary to enter into some form of revenue sharing arrangement with the branches. Another approach to encourage their full cooperation is for the branches to charge a monthly account management fee on accounts that do not maintain a certain minimum balance.

Summary and Conclusions Regarding the Critical Success Factors Regarding the Establishment of an Independent Microfinance Subsidiary:

To ensure the successful establishment and operation of an independent microfinance subsidiary, there are certain management and operational practices that will have to be abided by. These practices include:

(i). Strong support for the concept by senior management of the parent bank

(ii).The encouragement of a risk taking culture within the subsidiary

(iii). The need to appoint a dynamic personality as leader of the subsidiary

(iv). Flexibility in regards to providing both Islamic and Interest Bearing Loan Products

(v). Correct costing of loan products, so that they are profitable.

(vi). The need to understand the difference between the client base of SMEs and the commercial loan market.

(vii). The establishment of a clear career path for bank staff who are seconded to the subsidiary

(viii). The importance of adequately capitalizing the subsidiary, and allowing a reasonable time frame for proving the success or failure of the venture.

(ix). The need to allow the subsidiary to select both its client and staff without outside interference, and to develop its own operational and credit policies, procedures and practices.

(x). The need to develop a good working relationship with the staff at the branches of the parent bank that will be providing services to the subsidiary's clients.

11). THE ROLE OF COLLATERAL IN MICROFINANCE LENDING:

11.1). A major concern of commercial banks in the conduct of their intermediation role in the economy is the soundness of the loans that they are extending. Traditionally, the soundness of these loans has been assured by the taking of collateral over goods and chattels as security for the loans, which would be seized and sold in the case of default. The proceeds of these sales then would be used to repay the remaining principal and interest outstanding on the loan. The traditional banking viewpoint is that there is a linear relation between the quantity and quality of the collateral pledged, and the soundness and quality of the loan ("asset coverage"). For this approach to be effective, however, there needs to be an effective commercial legal code, whereby creditor's rights can be registered, and a functioning legal system that will uphold these rights. As noted in the section discussing legal issues[23], such a legal system currently does not exist in the WBGS.

11.2). Microfinance lending, however, does not emphasize the importance of formal collateral, primarily because the typical borrower does not have any worthwhile collateral (such as legitimate titles to land and buildings) to post as security. Rather, successful microfinance programs rely on cashflow lending, which is based on the ability of the client's business to generate cash in sufficient quantities to successfully service the loan. This necessitates an entirely different set of loan analytical skills by the loan officers than those required for collateral based lending. Moreover, this cash flow lending approach requires drawing a careful distinction between a clients capacity to repay, compared to his/her willingness to repay. This last mentioned point highlights the importance of "character" in the loan approval decision.

11.3). Instead of taking collateral in the form of goods and chattels, microfinance lending uses informal collateral, mainly through third party guarantees. This approach requires the borrower to provide third parties who guarantee to the lender that the borrower will repay the loan. Otherwise, the guarantors themselves will be liable for the repayment of the amount in default. This approach has proved effective in that when there is a loan default, the guarantors apply pressure on the defaulting borrower to repay the loan so that they, the guarantors, do not have to repay it.

11.4). The combination of careful cashflow analysis, and the informal collateral, has been effective in ensuring a high loan repayment rate, as discussed in the section "The Performance to Date of Microfinance in the WBGS". The loan repayment rate achieved by thirteen of the sixteen lenders prior to the commencement of the second Intifada was 99%. This loan repayment rate compares favorably with the commercial bank loan repayment rate of 90%-95%. These statistics indicate that the combination of the cash flow analysis, together with the ability, if necessary, to call on the guarantees, is an effective approach to ensuring loan repayment as is the traditional approach of accepting mortgages on goods and chattels.

11.5). For this informal collateral methodology to be effective, however, the lenders must have the legal right to enforce their claim. More importantly, the lenders must be viewed by the borrowers and the guarantors as having both that right, and the willingness, to act on this right. It appears that within the WBGS a legal mechanism for enforcing creditors rights against guarantors currently exist. This takes the form of the guarantors co-signing with the borrower a Bill of Exchange, which are regulated under Trade Law No. (12) of 1966 for the West Bank, and by the Cheques and Bills Ordinance no. (47) of 1929 in the Gaza Strip[24]. Under these laws, the co-signors of the Bill of Exchange assume the responsibility for honoring the payment of the Bill in the event that the debtor does not pay. This repayment can be enforced through the Execution Department of the Court System without the need to file a case against the defaulters. By having

[23] Legal Issues Regarding the Establishment of an Independent Microfinance Subsidiary.
[24] Source, "Analysis of the Policies, Laws, Regulations, and Supervision Practices etc." S. Charitonenko; p.26.

the Bill of Exchange notarized and registered, the creditors position is further strengthened, since the debtors/guarantors cannot claim forgery or fraud. While the ability to use these mechanisms currently is constrained, they do exist and will become more effective when the business environment returns to a more normal state.

11.6). The main benefit to microfinance lenders of this right, though, is that normally it does not have to be enforced. In most cases the notification to the guarantors of their obligations under the Bill of Exchange is sufficient to ensure that the loan is repaid. Thus, while the lenders may not find enforcing their rights under the legal system to be the most effective way of obtaining loan recoveries, it is extremely important that the borrowers and the guarantors know that lenders do have this option, and will exercise it if necessary. This creates a psychological pressure on borrowers to honor their obligations to the lender.

Summary and Conclusions Regarding the Role of Collateral in Microfinance Lending:

i). A major difference between normal lending practices and microfinance is that microfinance does not rely on the taking of physical collateral so as to obtain repayment of a loan. Rather, it relies on a thorough assessment of the client's capacity and willingness to repay, with additional support via Guarantees.

ii). International experience has shown that the lack of goods and chattels mortgages has not been a hindrance to achieving a high loan repayment rate, since the social pressure provided by the guarantors on the borrowers has proved effective.

iii). For this system of "social collateral" to be effective, however, there needs to be in place an effective way to register these legal rights, and these instruments exist in the WBGS through the use of Bills of Exchange. By having the guarantors co-sign the Bill of Exchange, and notarizing it, enables the lender to call on the guarantors to repay the loan in case of default, without having to go to court. This system provides a strong mechanism for using "social collateral" as an effective form of collateral, rather than having to take physical collateral. For this approach to be effective, however, the lender must be viewed by both the borrowers and the guarantors as being willing to exercise its rights. These mechanisms will become useful when the court system is functional once again.

12). LEGAL ISSUES REGARDING THE ESTABLISHMENT OF AN INDEPENDENT MICROFINANCE SUBSIDIARY.

12.1). The legal issues relating to the establishment of the independent microfinance subsidiary lie along two levels; the legal issues relating to undertaking lending activities in general, and the legal requirements for establishing an independent microfinance subsidiary.

The Legal Issues Relating to Undertaking Lending Activities in General:

12.2). Prior to making an investment in a commercial lending institution, either in the form of a bank or other finance company, the investor will need to be assured that any commercial disputes will be resolved fairly, and in a timely manner, through the commercial judicial system. Unfortunately, in WBGS this cannot be assumed at the current time. There is a tendency by many individuals to appeal to the security apparatus of the PA for resolution of commercial disputes, rather than relying on the judgments of civil courts[25]. Consequently, lenders are not able to rely on an impartial hearing of their claims. These shortcomings in the judicial system are commonly acknowledged, and there is widespread agreement on the steps that need to be taken to strengthen the legal system. These steps include the Presidential ratification of the "Basic Law" and "the Independence of the Judiciary Law", improved judicial facilities, and a greater degree of integration of the various holdover legal systems currently prevailing in WBGS. Laws relating to Security Interests in Movable Property Law, improved procedures for the registration of land titles, and the law relating to contracts will need to be introduced, or be approved, before creditors will feel that their rights are adequately protected[26]. Furthermore, the International Monetary Fund (IMF) has noted that the actions of the PA have not been conducive to private sector activity, and that inadequate transparency has deterred private investors[27].

12.3). In these circumstances it is difficult to recommend to prospective new investors that they commence lending activities in the WBGS, until the legal system is brought closer to international standards. For the existing commercial lenders, who have found ways to operate effectively despite these shortcomings, though, these issues should not be a deterrent. Thus, once the political-security situation returns to normal, the existing lenders could actively consider establishing an independent microfinance subsidiary before the above-mentioned legal reforms are implemented.

The Legal Requirements For Establishing An Independent Microfinance Subsidiary:

12.4). The legal aspects that will specifically relate to an independent microfinance subsidiary are as follows:

Legal and Regulatory Oversight by the Palestinian Monetary Authority (PMA):

12.5). While it is not proposed that the independent subsidiary will mobilize, or intermediate, savings; the legal counsel who advised on this issue felt that the PMA would declare such a subsidiary to be a "specialized lending institution" under the to be passed PMA Law number 2 of 1997. As such, it would be subject to PMA regulatory oversight. Since the law has yet to be passed, and no lending institution has been designated a "specialized lending institution" the regulatory and monetary requirements of such oversight have not been established. However, the fact that the moneychangers currently are supervised under a regulatory regime considerably less stringent than the applied to the commercial banks, suggests that the PMA will take a flexible

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[25] Analysis of the Policies, Laws, Regulations, and Supervision Practices Affecting the Environment for Microfinance in the WBGS, S. Charitonenko, February 2001.
[26] This section draws heavily on the report by S. Charitonenko.
[27] West Bank and Gaza Strip, Economic Developments in the Five Years since Oslo, IMF, 1999.

approach to regulating the independent subsidiary. Furthermore, a reasonable level of supervision could be beneficial since, in the eyes of the general public, it will add to the credibility of the concept.

12.6). Serious consideration should be given by both the parent commercial bank and USAID to propose to the PMA a draft regulatory regime for such subsidiaries. This will help ensure that the regulatory requirements balance the need for effective, but not onerous, reporting with allowing reasonable flexibility regarding activities by the subsidiary.

12.7). The procedures for registering the subsidiary as a limited company with the Ministry of Economics and Trade (MOET) are expected to be straightforward.

The Impact on the Independent Subsidiary of the PMA Requirements Regarding the Legal Lending Limit of Commercial Banks.

12.8). In common with most banking sector regulators, the PMA has established a ceiling, or legal lending limit, regarding the amount that a bank can lend to one client. The purpose of this requirement is to avoid too great a concentration of risk by over-lending to one borrower. The applicability of this regulation to the subsidiary is important, since loans from the parent will be the main source of its liquidity.

12.9). In the case of the PMA, the legal lending limit has been set at 10% of the capital of the parent commercial bank, rather than set as a percentage of any capital and reserves carried on the books of the branches currently undertaking banking activities within the WBGS[28]. Capital has been defined as the issued and paid up share capital, retained earnings and reserves of the bank, with the exception of the Loan Loss Reserve. These two factors, taken together, provide the branches of foreign banks currently operating here considerable latitude regarding the legal lending limit. For example, the capital and reserves of Arab Bank as of December 2000 was US$ 1.4 billion and the capital of Jordan National Bank (JNB) was US$ 91 million[29]. Thus these institutions would be allowed to lend US$ 140 million and US$9 million respectively to their subsidiaries without breaching the PMA's legal lending limit guidelines. At the current time, therefore, the established banks, should not encounter any problems in providing funding to their subsidiaries. Regarding new banks entering the WBGS for the first time, however, the regulations are somewhat different. Under the current regulations, Class A banks (commercial banks) must have a minimum capital of US$ 10 million, while Class B banks (Islamic banks) must have US$ 20 million. Thus, unless these new banks increase their equity base above the required minimum, their activities could be somewhat constrained by the legal lending limit.

[28] Discussion with B. Kominsky, 4/15/2002.
[29] Sources, the respective annual reports for 2000.

<u>Conclusions Regarding the Legal and Regulatory Constraints Regarding the Establishment of the Independent Microfinance Subsidiary:</u>

(i). The current legal and regulatory environment in the WBGS is not conducive to protection of creditors' rights in the event of a commercial dispute with borrowers. There is no clear separation between the enforcement of civil law and the local security apparatus, and many of the necessary steps to establish a fully functional civil law code and structure have yet to be undertaken. In these circumstances, it is not recommended that institutions that are not already operational in the WBGS consider establishing lending activities until the commercial legal code is established and becomes functional. For those institutions that are already established, and are aware of the prevailing legal circumstances, they could consider establishing an independent subsidiary preparatory to the development of the new civil code, but only after a political-security settlement has been reached.

(ii). Legal counsel advises that the PMA will likely require that a subsidiary will be declared "a specialized lending institution" under the to be passed PMA Law Number 2 of 1997 and, therefore, subject to PMA regulatory oversight. However, no detailed regulations have been written at this time. This creates the opportunity for both the prospective parent commercial bank, and USAID, to make recommendations as to the intensity of such oversight before these regulations are formalized.

(iii). It does not appear that the legal lending limit will place tight restrictions on the capacity of the existing commercial banks to extend loans to subsidiary companies, since the limit is tied to the capital base of the parent company. For new registered banks, however, their ability will be somewhat restricted unless more than the minimum capital requirements are invested as equity into the new bank.

13). THE POTENTIAL PROFITABILITY OF AN INDEPENDENT MICROFINANCE SUBSIDIARY.

Introduction:

13.1). As part of this proposal, projections of the likely profitability of an independent microfinance subsidiary have been prepared, assuming that it will be established after the current political/ social problems have been satisfactorily resolved. These projections, consisting of Income Statements and Balance Sheets, are included as Annex I of this report.

Basic Assumptions for the Projections:

13.2). This projection is based on the following assumptions.

13.3.). Currency to be Used: All loan disbursements, repayments, expenditures and income will be in US$.

13.4). Mode of Operations: The subsidiary will operate on a decentralized basis, with field agents spending most of their time in the field, rather than in the office. Each field agent will be equipped with a laptop computer that will be programmed to handle loan application and data gathering, together with financial analysis formats, and analytical report formats. The computers will store the relevant loan portfolio information for the field agent as well. Communications with the head office will be via the internet, which the field agent will access either from their home phones, or from internet cafes. The field agents will use their own motor vehicles, for which they will be paid a generous travel allowance. This approach already has proved successful with one of the banks currently operating in the WBGS. Transactions between the clients and the subsidiary will be handled through the clients opening either checking, or savings, accounts at the branches of the parent branch. Loans will be disbursed into these accounts, and repayments collected via an automatic deduction from these accounts.

13.5). Inflation: Inflation would be 10% p.a. in the first year, and 5% p.a. thereafter.

13.6). Capitalization of the Subsidiary: The issued and paid-up capital is projected at US$ 750,000. All additional capital needs will be funded by loans from the parent bank, at an interest rate of 10% per annum.

13.7). Terms and Conditions of Loans Extended to MSEs: The subsidiary will extend loans to creditworthy clients, with the maturity of these loans ranging between twelve months and three years. The average loan maturity is set at two years. Fees on the loans are set at a commission of 1% of the loan amount to be deducted at disbursement, and an interest rate of 1.25% flat per month. Repayments would be in equal monthly repayments of principal and interest. These interest rates and fees are in line with other microfinance lenders.

13.8). The Loan Loss Reserve: This is established as 2.5% of the gross loan portfolio outstanding.

13.9). The Case Load of Field Agents: For the first two years of operations, the case- load is set at 96 loans per field agent. For years three and four the caseload will rise to 108 loans per field agent, and in year 5 will further improve to 120 loans per field agent[30].

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[30] This caseload remains considerably below the international standard of 150 loans per field agent, using the individual loan methodology.

13.10). Loan Sizes: The initial average loan size at disbursement is projected as US$ 6,550[31]. This average loan disbursed will increase progressively to US$ 8,0000, reflecting the extension of progressively larger repeat loans to good clients, as well as the impact of inflation.

13.11). The Growth of the Loan Portfolio: The loan portfolio is projected to grow fairly rapidly, representing the progressive hiring of new field agents (3 additional field agents in Years 2-4), a progressive increase in field agent productivity and an incremental increase in the average loan size disbursed. The number of loans outstanding is projected as follows:

	No. of Loans	*US$ Portfolio*	*Avge Loan Size O/S US$*
Year 1	36	221,063	6,140
Year 2	324	1,561,163	4,818
Year 3	774	3,037,500	3,924
Year 4	1,134	4,495,500	3,964
Year 5	1,368	5,535,000	4,046

13.12). The Start-Up: It is projected that the first loan will be extended nine months after the start of the project. During this start-up period, staff will be hired and trained; and the policies, procedures and practices will be established and documented. The various operating systems will be designed and implemented during this period.

13.13). Management Structure: a General Manager will head the subsidiary. Additionally, there will be a Credit Manager, a MIS/IT manager and a Finance Manager/Accountant. The field agents (whose number will rise to twelve by year four) will report to supervisors[32], each of who will supervise six field agents. The supervisors will report directly to the General Manager. Initially, there will be only one office support staff. This staff, however, will rise progressively over time to three employees, including a driver.

13.14). The remuneration package for both field agents and supervisors will include a base salary and a performance bonus. The field agents will earn a base salary of US$ 1,000 per month plus a bonus of up to 60% of their base salary. Additionally, they will receive the usual benefits package plus a large travel allowance. The latter is based on the assumption that they will be using their own transportation in carrying out their duties. The supervisors will receive a base salary of US$1,300 a month, plus a performance bonus of up to 40% of the base salary, depending on the performance of the loan portfolio under their control. Also, they will receive a benefits package plus a smaller travel allowance. The other officers and staff will receive a straight salary and benefits package. All of the salary packages will increase in line with inflation.

13.15). Fixed Assets: It is projected that each field agent will be supplied with a laptop for use in the field. There will be a central office that will be adequately equipped with computers, servers, personal computers, leased lines, and office equipment and fixtures. A four- wheel drive vehicle also will be acquired. Details of these fixed assets are included in Page 4 of Annex I.

13.16). All assets will be depreciated over five years, on a straight- line basis.

13.17). Short Term Investments: Any surplus funds will be invested in the short-term money market, which currently yields 1.0%-1.5% p.a.

[31] The calculation of this amount is discussed in the section on the demand for microfinance in WBGS.
[32] One possible deployment would be to have individual supervisors for both the West Bank and the Gaza Strip.

Analysis of the Projections:

13.18). The financial projections forecast that the subsidiary will breakeven during year 3, and thereafter will achieve an increasing level of profitability.

Profitability:

13.19). During the first two years of operations, the subsidiary is projected to incur deficits of US$ 308,000 in year 1 and US$ 229, 000 in year 2. These losses are due to the following factors:

- The first loan will not be extended until month 10 in the first financial year. This relatively slow start-up is to allow for the formation of the legal entity, the establishment of the necessary infrastructure, the hiring and training of staff, the formulation of marketing strategies, and the preparations of the various procedures and practices manuals.

- Initially, the level of productivity will be low. This is the result of a natural caution regarding loan approvals, together with the inexperience of the field officers. During year three, though, productivity will improve as the subsidiary becomes more familiar with the SME market, field agents gain experience, and loans are made to repeat clients.

- In common with most lending institutions, the subsidiary needs to leverage off its initial capital outlays and fixed costs, so as to achieve economies of scale. The projected break-even point for each field officer, as calculated in Annex II is estimated at 120 loans outstanding , averaging US$3,430. This caseload per field agent is not achieved until late in year 3.

13.20). In years four and five, however, the subsidiary becomes highly profitable as the field agents achieve greater productivity, and the subsidiary is able to leverage off its fixed cost base.

13.21). The quality of the loan performance is expected to match that of most the microfinance providers prior to the second Intifada, when most of them achieved repayment rates of 99%.

13.22). The ability of the subsidiary, assuming the worst case basis that it is a new entry, to reach a projected total of approximately 1,400 clients, is reasonable since it represents 8% of the estimated potential market pool of clients who are credit worthy and willing to borrow. Even it elects to focus on those clients above the breakeven loan size (estimated at $3,430), this would represent only a 10% market share of the potential market niche.

13.23). The projections allow for a generous (by WBGS standards) bonus system of on average 60% of the base monthly salary for field agents, and a bonus of 40% of the monthly base salary for the supervisors. Furthermore, these costs, together with most of the other operating costs, are linked to the inflation rate.

13.24). The forecast projects that the return on average equity (ROE) and the return on average assets (ROA) for the subsidiary will be as follows.

	% Return on Average Equity	*% Return on Average Assets*
Year 1	-	-
Year 2	(70.18)	(5.59)
Year 3	(7.40)	(0.16)
Year 4	48.29	0.84
Year 5	72.97	1.88

13.25). These statistics compare extremely favorably with the general commercial bank performance in the WBGS regarding the return on average equity and the return on average assets of 10%-12% and 1.00%-1.25% respectively.

13.26). The parent commercial bank, however, also earns considerable profits from lending to the subsidiary. The model projects that the parent will finance the incremental capital requirements of the subsidiary above the initial capital outlay of US$750,000 by loans to the subsidiary. These loans are projected to reach US$ 4.7 million by the end of year five. With the interest rate charged to banks' best clients of 10% p.a. and the weighted average cost of funds to commercial banks estimated to be 2%, the parent commercial bank earns a gross interest spread on the loan to the subsidiary of 8% p.a.. The gross earnings on the loans to the microfinance subsidiary, therefore, rise in tandem with the amount of loans to the subsidiary, rising from US$55,000 in year two, to US$353,000 in Year five. Consequently, the overall earnings to the parent from the establishment of a specialized microfinance subsidiary are considerable; as detailed below:

Year	*Net Income From Subsid.*	*Income From Loan to Subsid.*	*Total*	*Cumulative Total*
	US$	*US$*	*US$*	*US$*
Year 1	(308,319)	0	(308,319)	(308,319)
Year 2	(229,450)	55,122	(174,328)	(482,647)
Year 3	(15,151)	168,187	153,036	(329,611)
Year 4	125,461	277,274	402,735	73,124
Year 5	370,574	353,356	723,930	797,054

13.27). Furthermore, there would be some additional, although unquantifiable, earnings from the balances from the savings/checking accounts that borrowers would have to open with the parent commercial bank. These earnings will be more material if service fees are charged on these accounts.

13.28). The five year projection indicates that a wholly owned subsidiary will generate substantial earnings for the parent commercial bank, even after general overhead costs are allocated against the revenue earnt on the loan from the parent to the subsidiary.

Capitalization:

13.29). The capitalization necessary for the launch of the subsidiary has been set at US$ 750,000, based on the experience of similar entities within the region. The amount of capitalization can be varied according to the individual projections of demand, and in accordance with the investment policies of the parent bank. The capitalization, however, should be sufficient to cover both the initial capital expenditures and the accumulated losses until the subsidiary generates a profit. Debt capital only should be used for funding the portfolio, thereby ensuring that the spread between the cost of funds and the yield on the portfolio is maximized.

Liquidity:

13.30). By the use of the independent microfinance subsidiary structure, the only limitations on the liquidity of the subsidiary will be the legal lending limit of the parent commercial bank, and the parent's appetite for risk.

13.31). As discussed in the section "Legal Issues Regarding the Establishment of an Independent Microfinance Subsidiary" the legal lending limit, as currently interpreted, is not expected to overly restrict the supply of the projected necessary liquidity from the parent to the subsidiary in the case of the existing banks. For newly established banks, however, this could be a constraint for the first few years

13.32). The parent's acceptable level of risk, though, will have to be measured by the ongoing performance of the subsidiary regarding the quality of its loan portfolio. Based on the historical performance of lenders to the SME market, though, this is not seen as a major restriction to the liquidity of the subsidiary at this stage.

Sensitivity Analysis:

13.33). To measure the impact of variations between actual outcomes and the projected model, the following sensitivity analysis has been undertaken.

The Field Officer Case Load (Productivity) is 10% Less Than Projected.

13.34). Should the productivity fall short of the (modestly) projected case load per field agent of 96 loans for year 1 and 2, 108 loans for years 3 and 4 and 120 loans in year 5, the following income and expense categories are effected: Commission, interest earnt on loans, the Provision for Loan Losses and the interest paid on borrowings. It also impacts the interest earnt by the parent on the loan to the subsidiary. The net result of these changes are as follows

	Subsidiary Income	*Interest on Loan by Parent*	*Total*	*Cumulative Total*
Year 1	(308,592)	-	(308,592)	(308,592)
Year 2	(251,272)	41,000	(210,272)	(518,864)
Year 3	(72,609)	156,000	83,391	(435,473)
Year 4	39,417	240,000	279,417	(156,056)
Year 5	256,398	275,000	531,398	375,342

13.35). The drop in the productivity by the field agents impacts the results of the subsidiary, as well as the earnings by the parent on the loan extended by it to the subsidiary. The break-even point for the subsidiary is delayed until year 4, and the overall level of profitability declines from US$ 797,000 to US$ 375,000. While the program remains profitable overall, this sensitivity analysis highlights the importance of productivity per field agent to its success. As noted earlier, the projected productivity is considerably lower than the international standard, and for years 1-4 approximates the goal established by one of the commercial banks currently undertaking microfinance lending in WBGS.

Due to Market Conditions, the One Per Cent Commission Charged on Disbursement is Abolished.

13.36). The model projects that the loans made by the subsidiary to the SMEs will be priced at 1.25% per month flat, plus a commission of 1% of the loan amount, to be deducted on disbursement. Should competitive pressures force the subsidiary to abolish the commission, the impact on earnings will be as follows:

	Subsidiary Income	*Interest on Loan by Parent*	*Total*	*Cumulative Total*
Year 1	(310,677)	-	(310,677)	(310,677)
Year 2	(250,000)	56,000	(194,000)	(504,677)
Year 3	(53,000)	171,000	118,000	(386,677)
Year 4	69,000	283,000	352,000	(34,677)
Year 5	300,000	364,000	664,000	629,323

13.37). The abolition of the commission has a moderate impact on the profitability of the subsidiary, resulting in a decline in gross income and an increase in borrowing costs. Taken together, these delay the break-even point for the subsidiary from year 3 to year 4. This drop in income, however, is offset to a large degree by increased earnings on the loan by the parent to the subsidiary. Under this scenario, the combined loss in income to the consolidated entity is approximately US$ 160,000 over the five-year period, which still leaves the overall operation strongly profitable.

The Parent Company's Legal Lending Limit is Restricted to US$4 Million.

13.38). This scenario pre-supposes that a regulatory limit of US$ 4 million is placed on the parent's ability to fund the operations of the subsidiary through debt capital, and the parent elects not to finance further expansion by increasing the subscribed equity of the subsidiary. This would impact interest on the loan portfolio, commissions, the provision for loan losses, interest paid on borrowings by the subsidiary, and interest earnt on loans extended by the parent to the subsidiary.

	Subsidiary Income	*Interest on Loan by Parent*	*Total*	*Cumulative Total*
Year 1	(308,319)	-	(308,319)	(308,319)
Year 2	(229,450)	55,212	(174,328)	(482,647)
Year 3	(15,151)	168,187	153,035	(329,612)
Year 4	108,781	272,000	380,781	51,169
Year 5	232,162	320,000	552,162	603,331

13.39). The operations of the subsidiary are not impacted until year four of operations, when the debt ceiling of US$4 million would be reached. After year 5 earnings probably would continue to rise slowly, as retained earning then could be re-invested in the ongoing operations of the subsidiary. For the five- year period, though, the effect of this borrowing cap would be to reduce the combined cumulative earnings by about US$190,000 to approximately US$603,000. Nonetheless, the overall earnings for the consolidated group remain strongly positive.

The Level of Loan Losses Increases From 2.5% to 5.0% of the Loan Portfolio.

13.40). This analysis measures the impact on the projected earnings, if the quality of the loan portfolio deteriorate to the extent that the loan loss reserve is raised to 5% of the total portfolio outstanding. The effect on the consolidated earnings is as follows:

	Subsidiary Income	*Interest on Loan by Parent*	*Total*	*Cumulative Total*
Year 1	(313,846)	-	(313,846)	(313,846)
Year 2	(266,303)	58,000	(208,303)	(522,149)
Year 3	(55,750)	173,000	117,250	(404,899)
Year 4	80,000	283,000	363,000	(41,899)
Year 5	322,000	362,000	684,000	642,100

13.41). The break-even point for the subsidiary is delayed until year four, after which operations turn solidly profitable. The decline in the profitability of the subsidiary is partially offset by increased earnings on the loan by the parent to the subsidiary, so that the overall negative impact of such a deterioration would amount to approximately US$ 155,000 over the five-year period. The venture, however, remains solidly profitable for the five- year period.

The Parent Commercial Bank Decreases its Capital Investment in the Subsidiary by US$100,000:

13.42). If the parent commercial bank decides to reduce its capital investment in the subsidiary by US$100,000, and fund this reduction by additional debt, the results would be as follows:

	Subsidiary Income	Interest on Loan by Parent	Total	Cumulative Total
Year 1	(310,000)	-	(310,000)	(310,000)
Year 2	(240,000)	63,000	(177,000)	(487,000)
Year 3	(26,000)	177,000	151,000	(336,000)
Year 4	113,000	287,000	400,000	64,000
Year 5	358,000	364,000	722,000	786,000

13.43). The reduction in the earnings of the subsidiary, are partially offset by the increased earnings to the parent from the increased loan amount extended to the subsidiary. In total this has very little impact on the pre-tax profit earnt by the combined entity, with the consolidated income declining only by US$11,000.

Summary and Conclusions Regarding the Potential Profitability of an Independent Microfinance Subsidiary.

(i). The projections included in Annex I of this report indicate that the independent microfinance subsidiary will basically break-even in year three of operations, and turn solidly profitable in years four and five. For these years the return on equity (US$ 750,000) and return on assets is forecast to be 48% and 73% for ROE and 0.84% and 1.88% respectively for ROA. These projections have been based on conservative assumptions, particularly in regards to the projected caseload of the field agents, which have been set considerably below international standards.

(ii). The parent commercial banks will derive considerable earnings on the loans it makes to the subsidiary for on-lending to the SME sector. With an estimated cost of funds of 2% p.a., and a lending rate of 10% p.a., the gross profit on these loans rises sharply, from US$ 55,000 in year two to US$ 355,000 in year five. This makes the overall venture extremely profitable for the parent bank.

(iii). Sensitivity analysis suggests that under the various scenarios the break-even point is delayed until year four, but thereafter the venture becomes solidly profitable. This is somewhat due to the decline in the profitability of the subsidiary, which is partially offset by the increase in earnings to the parent from the loan made to the subsidiary. Even if the field agents cannot reach the (low) productivity target, the combined earnings over the five- year period will still approximate US$ 375,000. Nonetheless, this decline does highlight the role of scale in microfinance lending, the importance of productivity, and the need to leverage off the fixed cost base.

14). RISKS:

14.1). The specific risks to the successful operation of an independent microfinance subsidiary, as opposed to the general risks of undertaking commercial loan activities in the WBGS, are identified as follows:

The Implementation of Onerous Regulatory Requirements by the Palestine Monetary Authority.

14.2). As noted in the section on Legal Issues[33] it seems likely that the subsidiary will be subject to legal and regulatory oversight by the PMA, but the intensity of that oversight is unclear. Based on the level of oversight currently in effect for moneychangers operating in the WBGS, any new regulations should not be overly heavy-handed. Nonetheless, to help ensure that the level of oversight is appropriate, it is suggested that the parent bank consider proposing regulatory guidelines to the PMA whilst they are in the drafting stage. This will help ensure that the final regulations relating to the subsidiary are appropriate for its level of operations.

14.3). This risk should be manageable, particularly if the parent commercial bank works with the PMA in the drafting of the relevant regulations.

The Public Perception Regarding the Obligations of Debtors to Repay Loans

14.4). The ongoing studies regarding financial activities in the WBGS indicate that, despite some weakening over the past eighteen months, the credit culture of the SME sector has historically been quite good. This perception as it relates to bank borrowing is probably due in part to the fact that commercial banks were viewed as both having the right, and the willingness, to enforce their rights in the case of default.

14.5). The public may, however, view a lending institution that is not a commercial bank somewhat differently, and not be as committed to repaying the loan as they would be to a commercial bank lender. To manage this risk, the subsidiary will have to make it extremely clear to the borrowers, both verbally and in the loan agreements, that there will be zero tolerance towards loan defaulters. This will include using the full force of the law to enforce their creditor's rights.

14.6). With a professional approach to this risk; and prompt, firm action with the initial batch of delinquent loans, this risk should remain manageable.

Loss of Management Control by the Parent Commercial Bank:

14.7). One of the critical success factors for the success of this approach is the granting to the subsidiary sufficient independence to manage its own affairs. There is, however, a clear risk that if the parent adopts a completely "hands off" approach, the subsidiary could spin out of control. The parent commercial bank, therefore, needs to strike a balance between independence and control in its dealings with the subsidiary.

14.8). This can be best achieved by good governance at the Board Level. The Board Chairperson should be a senior staff member of the parent, who has a good knowledge of, and interest in, microfinance. Additionally, the Board should meet on a regular basis, preferably at least quarterly, and to receive frequent, detailed reports. Furthermore, the Board, or the Chairman, must authorize any deviations from the standardized policies, procedures and practices.

[33] "Legal Issues Regarding the Establishment of an Independent Microfinance Subsidiary."

14.9). The application of good governance practices should minimize this risk to an acceptable level.

Summary and Conclusion Relating to the Recognition and Management of Risks:

(i). Three risks have been identified as relating specifically to the establishment of an independent microfinance subsidiary, as opposed to generic risks of microfinance lending. These risks relate to regulatory and oversight risk, public perception risk, and the danger of the parent commercial bank losing control over the subsidiary. These risks can be managed by working together with the PMA in drafting the regulations regarding "specialized lending institutions", clearly and publicly adopting a policy of zero tolerance towards loan defaults, and the implementation of good governance practices at the Executive Board level. All of these risks are considered to be manageable.

15). PROCEDURE FOR THE ESTABLISHMENT AND IMPLEMENTATION OF AN INDEPENDENT SUBSIDIARY.

15.1). Detailed below are the necessary procedural steps that will have to be taken to establish the independent microfinance subsidiary. The basic goal is to have the subsidiary registered, staffed and operational within a nine- month period. These steps are outlined in chronological order, and should be reviewed in conjunction with the time chart outlined in Appendix III. As noted below, many of these steps can be undertaken simultaneously.

Month 1:

The Parent Commercial Bank Confirms its Interest in the SME Market:

15.2). The senior management of the parent commercial bank takes the strategic decision that it is interested in servicing the SME market, as long as it can be undertaken on a profitable basis. Furthermore, they establish a realistic time period for the microfinance subsidiary to achieve break-even.

The Establishment of a Working Group to Establish a Detailed Strategy:

15.3). The parent commercial bank establishes a small working group to identify and prepare a detailed marketing strategy for the subsidiary. The parent company may consider hiring an external consultant to assist with this study. The aim of this exercise is to clearly identify the geographic areas where the subsidiary will operate, the industries to be included in the target market, identify and appraise the competition. The group also should confirm that providing all field agents with laptops and having them communicate with the Head Office via the internet, will be fully functional in the proposed areas of operation. Finally, the group is to make recommendations as to whether the subsidiary initially will commence operations in the West Bank, or in the Gaza Strip, or in both simultaneously.

Clarify The Legal Issues Regarding the Establishment of the Specialized Subsidiaries and the Legal Standing of Creditors Regarding Disputes with Borrowers Over Loan Repayment Defaults.

15.4). The working group should obtain legal advice from the Bank's in-house legal counsel regarding the most appropriate legal structure to be used for the subsidiary company. Additionally, the legal counsel is to advise on the current, and likely future, position of the PA and PMA regarding the strengthening the commercial legal code under which the subsidiary will be operating.

Propose Regulatory Oversight Principles for Independent Subsidiaries to the PMA:

15.5). Commence work on drafting proposed legal and regulatory oversight guidelines for specialized microfinance subsidiaries for forwarding to the PMA. This can be undertaken by in-house legal counsel and the working group.

Month 2:

Establishment of the Initial Capitalization of the Subsidiary:

15.6). Senior management of the parent commercial should establish the amount of risk capital that is to be invested into the subsidiary, and identify from where these funds are to be sourced. The suggested amount is US$ 750,000.

Appoint Senior Bank Staff Member to be Chairman of the Board of the Subsidiary

15.7). Senior management appoints a senior bank staff member to be the Chairman of the Board of the Subsidiary. This individual will be responsible for the establishment of the subsidiary, and must be both dynamic and knowledgeable about microfinance.

Prepare a Five- Year Business Plan:

15.8). Under the oversight of the Chairman of the Subsidiary, commence the preparation of a five- year business plan. This plan will include the establishment of financial targets, identification of the various loan products, and the terms and conditions of these loans. Furthermore, it will include the necessary implementation plans. Job descriptions for the senior officers of the subsidiary are to be prepared.

Month 3:

Submission of Draft Oversight Regulations to the PMA:

15.9). After the completion and review of the oversight regulations, these draft regulations should be submitted to the PMA for approval.

Month 4:

Establish the Governance Structure of the Subsidiary:

15.10). The number and composition of the Board of Directors is to be established. Simultaneously, the management structure and positions of the subsidiary itself are to be identified.

Appoint Members of the Board of Directors of the Subsidiary:

15.11). Members of the subsidiary's Board of Directors are to be identified and appointed.

Complete the Preparation of the Five-Year Business Plan:

15.12). The five- year business plan is finalized for presentation to the newly appointed Board of Directors.

Preliminary Identification of Candidates for the Senior Staff Positions of the Subsidiary:

15.13). The staff of the parent commercial bank that are to be seconded to the subsidiary as senior management are to be tentatively identified.

Month 5:

Finalize Regulatory Requirements for the Subsidiary with the PMA.

15.14). The regulations relating to registering the subsidiary as a specialized lending institution are to be finalized and gazetted.

Final Decision to Proceed with the Establishment of the Subsidiary:

15.15). After reviewing the five year business plan, and based on the intensity of the PMA regulatory requirements, the Board of Directors makes the final decision to proceed with the establishment of the subsidiary, or to cancel the project.

Register the Subsidiary as a Private Limited Company with the Ministry of Economics and Trade.

15.16). As required by law, the subsidiary will need to be registered as a private limited company with the MEOT, and be assigned the appropriate business classification number.

Commence Work on the MIS System:

15.17). Initially, the system could be relatively simple (a combination of a standard accounting package and an EXCEL based loan tracking system). When the operations grow to scale, the system would be upgraded.

Month 6:

Register the Subsidiary with the Palestine Monetary Authority:

15.18). After registration with the MEOT, the subsidiary is registered with the PMA.

Select and Equip the Head Office Location:

15.19).The Head Office of the subsidiary is to be identified and established. With the strategy of field agents communicating with the Head Office primarily by the Internet, a good communications system is critical. By this time a strategic decision will have to be made as to whether there will be a separate office in the Gaza Strip.

Recruit the Senior Management of the Subsidiary:

15.20). The senior staff of the subsidiary will be recruited and trained. The positions to be filled will be for:

The General Manager
The Credit Manager
The MIS Manager
The Finance Manager/ Accountant

Prepare the Various Manuals and Guidelines Necessary for Operational Effectiveness:

15.21). Commence work on the following manuals for use by the subsidiary. A consultant should be retained to assist in the drafting of these manuals:

The Credit Manual (drafted by the Credit Manager)
The MIS Manuals (drafted by the MIS Manager)
The Operations Manuals for Policies, Procedures and Practices (drafted by the General Manager).
The Accounting, Reporting and Financial Management Manuals (drafted by the Finance Manager/Accountant).

Prepare the Necessary Legal Documentation for Loans:

15.22). The necessary legal documentation for the Loans are to be completed, approved and printed.

Commence Hiring of Field Agents and a Loan Supervisor:

15.23). Senior management of the subsidiary commences hiring of the field agents and a loan supervisor.

Month 7:

Supervisors And Field Agents Undergo Microfinance Training.

15.24). The supervisors and field agents commence training in microfinance. This training could be provided in Palestine, through an arrangement with the Institute of Banking Studies of Jordan.

Management of the Subsidiary to Establish a Working Partnership with Branch Managers.

15.25). The subsidiary establishes a mutually satisfactory working relationship with the managers of the various branches that will service the accounts of the clients of the subsidiary. This is to ensure that the subsidiary's clients are treated in a professional manner by branch staff. This arrangement may necessitate a revenue sharing agreement, or fees charged on clients' accounts.

Month 8:

Purchase of Laptops and Building the Network for Access to the Internet:

15.26). The subsidiary acquires the laptops and programs them for the transmittal of data between the Head Office and the field, via the internet.

Commence Advertising Campaign:

15.27). The subsidiary commences its advertising campaign, through television, radio and newspaper advertisements, as well as by pamphlets, so as to build name awareness and recognition.

Month 9:

Complete the Training of the Field Agents and the Loan Supervisors:

15.28). Staff training is completed at this time.

Test the MIS System:

15.29). The MIS system is to be tested and any operational "bugs" are to be worked out of the system. The system then is to be adequately documented.

Complete the Final Review and Approve the Necessary Legal Documentation. The Manuals for Operational Policies, Procedures and Practices; Credit; Operating Procedures; and Accounting and Financial Reporting Also are Approved.

15.30). All the necessary documentation for loan applications, loan approvals and loan agreements are finalized and approved by Legal Counsel. Additionally, the various operational and procedures manuals are to be finalized and approved.

Month 10:

Commence Financial Activities:

15.31). The subsidiary commences lending activities, initially with, say, three field agents and one supervisor. These activities should be concentrated in contiguous areas, which will be expanded from at a later date.

16). SUMMARY AND CONCLUSION.

16.1). There is a strong case for utilizing an independent subsidiary as an effective tool for providing microfinance. The strategic, operational, financial management and psychological benefits that such a mechanism can provide outweigh the advantages offered by adopting an integrated approach through a commercial bank network.

16.2). In addition to these above advantages, the venture can be very profitable to the parent commercial bank. The subsidiary itself reaches the break-even point in three years, and in years four and five the returns on average equity and the returns on average total assets exceed those achieved by the commercial banking sector in general. Furthermore, the parent commercial bank earns profits on the loans that it will have to extend to the subsidiary. These earnings are substantial, and with the parent having oversight over the lending policies of the subsidiary, the risk should be lower than with other loans in the parent commercial bank's loan portfolio.

16.3). There are several risks relating to the establishment of the subsidiary, with the most notable being the legal and regulatory risk. The parent commercial bank should be able to manage this risk, though, by adopting a pro-active approach in its negotiations with the PMA.

16.4). The overall conclusion is that the adoption of an independent microfinance subsidiary is both feasible and the preferable approach for a commercial bank that wants to service the SME market. But the launching of such a strategy is not recommended at this point in time. It is proposed that no action be taken to encourage the developments of specialized subsidiaries until the current political crisis is resolved and that the parent commercial bank can plan for the future with a reasonable certainty of social and economic stability. Furthermore, new entrants in to the microfinance field are advised to defer investing in this market until a functional civil legal code is operational within the WBGS.

ANNEX I: FINANCIAL PROJECTIONS

PROJECTED INCOME AND EXPENSE STATEMENT

	Year 1	Year 2	Year 3	Year 4	Year 5
FINANCIAL INCOME					
Commissions	2,358	19,440	34,020	48,600	57,600
Interest on Loans	5,895	302,670	788,850	1,202,850	1,563,525
Interest on Investments	1,600	750			
Total Financial Income	9,853	322,860	822,870	1,251,450	1,621,125
FINANCIAL COSTS					
Interest on Short Term Debt		70,039	211,387	354,558	453,380
Interest on Long Term Debt					
Total Financial Costs	0	70,039	211,387	354,558	453,380
Loan Loss Provision	5,527	33,503	36,908	36,450	25,988
NET FINANCIAL MARGIN	4,326	219,318	574,575	860,443	1,141,757
EXPENSES					
Salaries and Benefits-					
Field Agents	68,400	150,480	237,006	331,808	348,399
Supervisors	26,040	28,644	60,152	63,160	66,318
General Manager	31,000	34,100	35,805	37,595	39,475
Finance Manager	22,000	24,200	25,410	26,681	28,015
MIS Manager	24,000	26,400	27,720	29,106	30,561
Credit Manager	22,000	24,200	25,410	26,681	28,015
Support Staff	14,000	30,800	32,340	50,936	53,482
Rent	24,000	25,200	26,460	27,783	29,172
Utilities	2,400	2,640	2,772	2,911	3,056
Travel and Per Diem	3,750	30,360	49,203	66,944	70,291
Office Expenses	12,000	13,200	13,860	14,553	15,281
Depreciation	19,360	21,880	25,840	27,940	30,040
Motor Vehicle Expenses	7,695	8,465	8,888	9,332	9,799
Training costs	24,000	15,000	5,000	5,000	4,000
Other	12,000	13,200	13,860	14,553	15,281
TOTAL OPERATING EXPENSES	312,645	448,769	589,726	734,982	771,184
NET INCOME FROM OPERATIONS	-308,319	-229,450	-15,151	125,461	370,574

PROJECTED BALANCE SHEET

	Year 1	Year 2	Year 3	Year 4	Year 5
ASSETS					
Current Assets					
Cash at Bank	10,000	10,000	10,000	10,000	10,000
Short Term Investments	148,705				
Gross Loan Portfolio	221,063	1,561,163	3,037,500	4,495,500	5,535,000
Loan Loss Reserve	5,527	39,029	75,938	112,388	138,375
Net Portfolio Outstanding	215,536	1,522,133	2,961,563	4,383,113	5,396,625
Other Current Assets					
Total Current Assets	374,241	1,532,133	2,971,563	4,393,113	5,406,625
Long Term Assets					
Fixed Assets	96,800	109,400	129,200	139,700	150,200
Provision for Depreciation	19,360	41,240	67,080	95,020	125,060
Net Fixed Assets	77,440	68,160	62,120	44,680	25,140
Long Term Investments					
Total Long Term Assets	77,440	68,160	62,120	44,680	25,140
Total Assets	451,681	1,600,293	3,033,683	4,437,793	5,431,765
LIABILITIES					
Current Liabilities					
Short Term Borrowings	0	1,378,062	2,826,603	4,105,252	4,728,651
Other Current Liabilities	10,000	10,000	10,000	10,000	10,000
Total Current Liabilities	10,000	1,388,062	2,836,603	4,115,252	4,738,651
Long Term Liabilities					
Long Term Borrowings	0	0	0	0	0
EQUITY					
Shareholder Capital	750,000	750,000	750,000	750,000	750,000
Accumulated Results	0	-308,319	-537,769	-552,920	-427,459
Current Years Results	-308,319	-229,450	-15,151	125,461	370,574
Total Equity	441,681	212,231	197,080	322,541	693,114
Total Liabilities and Equity	451,681	1,600,293	3,033,683	4,437,793	5,431,765
Funding Gap	-1	0	0	0	0
For Subsidiary					
Return on Average Equity		-70.18%	-7.40%	48.29%	72.97%
Return on Average Assets		-5.59%	-0.16%	0.84%	1.88%
Return on Original Investment	-41.11%	-30.59%	-2.02%	16.73%	49.41%
Combined Subsidiary and Parent					
Profit from Subsidiary	-308,319	-229,450	-15,151	125,461	370,574
Profit from loan to Subsidiary	0	55,122	168,187	277,274	353,356
Combined Profit	-308,319	-174,328	153,035	402,735	723,930

PROJECTED PORTFOLIO, LOAN OFFICERS, AND REVENUE

	Year 1	Year 2	Year 3	Year 4	Year 5
Number of loan officers	3	6	9	12	12
Number of loan officer months	9	72	108	144	144
Number of loans disbursed per month per loan officer	4	4	4.5	4.5	5
Average loan size disbursed	6550	6750	7000	7500	8000
Annual loan disbursement	235800	1944000	3402000	4860000	5760000
Amount of loans disbursed	235800	1944000	3402000	4860000	5760000
Amount of Loans Repaid	14738	603900	1925663	3402000	4720500
Balance O/S End of Year	221063	1561163	3037500	4495500	5535000
Loan Loss Reserve	5527	39029	75938	112388	138375
Commission on Disbursement 0.01	2358	19440	34020	48600	57600
Interest Income 1.25% flat	5895	302670	788850	1202850	1563525

BASIC ASSUMPTIONS FOR THE PROJECTIONS

	Year 1	Year 2	Year 3	Year 4	Year 5
Number of Field Agents	3	6	9	12	12
Salary of Field Agents	12,000	13,200	13,860	14,553	15,281
Bonus	7,200	7,920	8,316	8,732	9,168
Benefits	3,600	3,960	4,158	4,366	4,584
Travel Allowance	4,200	4,620	4,851	5,094	5,348
Total Cost of Salary, Bonus and Benefits	68,400	150,480	237,006	331,808	348,399
Supervisor					
Number of Supervisors	1	1	2	2	2
Salary	15,600	17,160	18,018	18,919	19,865
Bonus	6,240	6,864	7,207	7,568	7,946
Benefits	4,200	4,620	4,851	5,094	5,348
Travel	2,400	2,640	2,772	2,911	3,056
Total	26,040	28,644	30,076	31,580	33,159
Total Supervisor Cost excl travel	26,040	28,644	60,152	63,160	66,318
Salary, Bonus and Benefits					
General Manager	31,000	34,100	35,805	37,595	39,475
Credit Manager	22,000	24,200	25,410	26,681	28,015
Finance Manager	22,000	24,200	25,410	26,681	28,015
MIS Manager	24,000	26,400	27,720	29,106	30,561
Office staff	14,000	15,400	16,170	16,979	17,827
Number	1	2	2	3	3
Amount	14,000	30,800	32,340	50,936	53,482

	COST US$	QUANTITY	YEAR 1 US$	YEAR 2 US$	YEAR 3 US$
Laptop	3,500	15	10,500	10,500	10,500
Server	6,700	1	6,700		
Personal Computers	2,100	6	8,400	2,100	2,100
Software	10,000	1	10,000		
Motor Vehicle	42,000	1	42,000		
Printers/fax/copiers	4,200	2	4,200		4,200
Communications Infrastructure	8,000	1	8,000		
Office Furniture and Fixtures	10,000	1	7,000		3,000
TOTAL			96,800	12,600	19,800
Total Assets			96,800	109,400	129,200
Depreciation @20% p.a.			19,360	21,880	25,840
Motor Vehicle Expenses					
Fuel	4,320				
Registration	175				
Insurance	1,400				
Repairs and Maintenance	1,800				
Total	7,695				
Inflation Rate %		0.10	0.05	0.05	0.05

Training

	Cost	Year 1	Year 2	Year 3	Year 4
Microfinance Course	1000	7000	3000	3000	3000
Consultant	25000	15000	10000		
Sundry		2000	2000	2000	2000
Total		24000	15000	5000	5000

ANNEX II:

BREAK-EVEN CALCULATIONS:

The break-even loan calculations are based on the productivity and cost basis for year five of operations, when the subsidiary will have achieved some economies of scale.

	Annual Cost	Monthly Cost
Cost of the Field Agent:		
Salary and Bonus	29,033	2,419
Travel and Per Diem	5,348	446
Supervisor:		
Annual Cost US$ 33,159 Amongst 6 field agents	5,526	461
Overhead US$ 286,176 amongst 12 field agents	23,848	1,987
Total costs per Field Agent	63,755	5,313

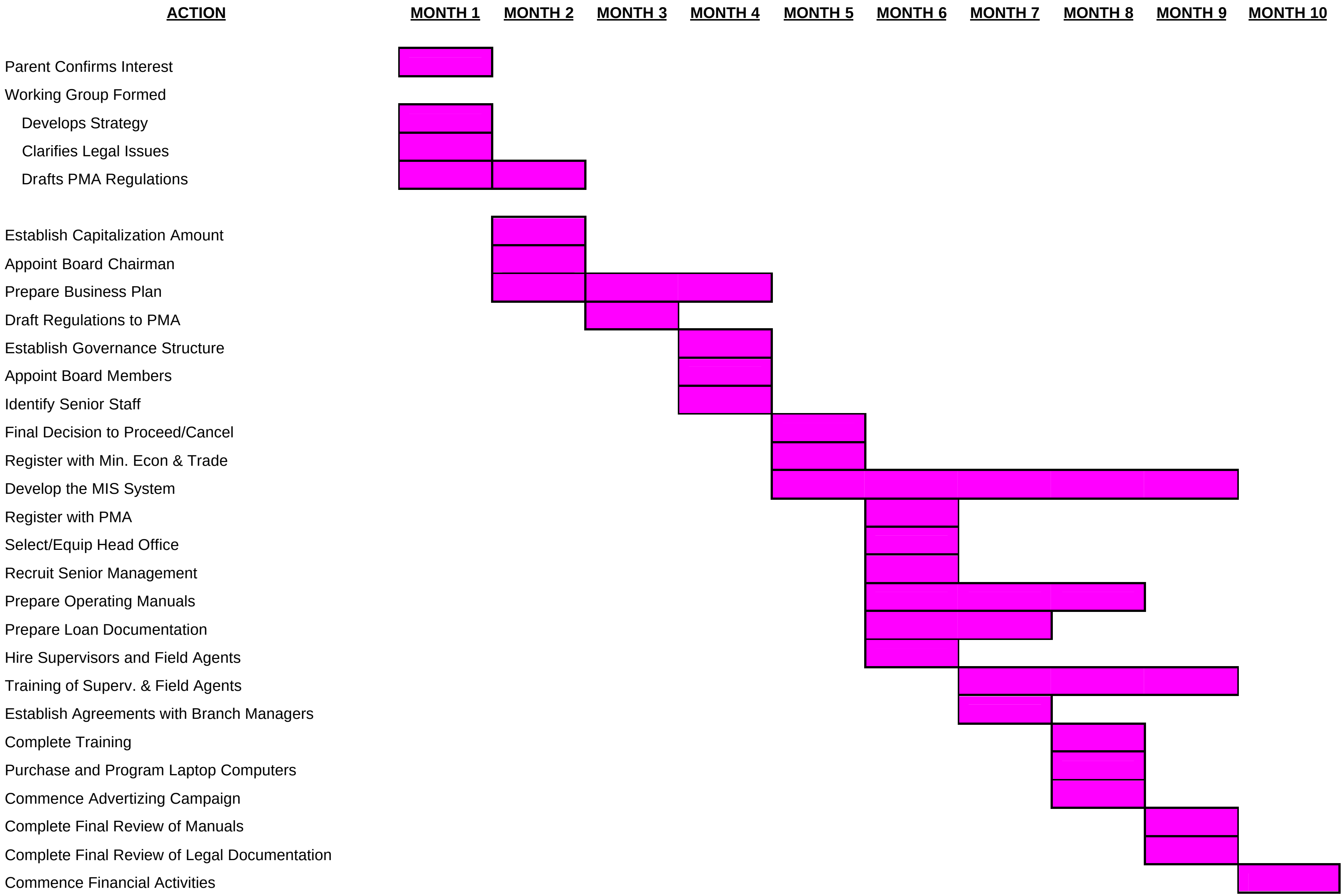
Projected Productivity Rate: 120 loans.

Average loan size disbursed needed to cover these costs = US$3,430

Commission @1% =US$ 34* 60	= 2,040 p.a.
Interest at 1.25% flat per month On US$3,430*120*1.25%*12	=61,740 p.a
Total	=63,780 p.a.

ANNEX III: TIME LINE FOR THE ESTABLISHMENT OF A SUBSIDIARY

IMPLEMENTATION STEPS FOR THE ESTABLISHMENT OF THE SUBSIDIARY



ANNEX IV.
DOCUMENTS READ DURING THE COURSE OF THE ASSIGNMENT.

Analysis of the Policies, Laws, Regulations, and Supervision Practices Affecting the Environment for Microfinance in the WBGS. S. Charitonenko, February 2001.

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Jordan National Bank, Annual Report, 2000.

Making Microfinance work in the Middle East and North Africa. J. Brandsma and L. Hart (undated).

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Palestinian Banking Corporation. Draft Proposal for Establishing a Palestinian Microfinancing Bank. Undated.

Palestinian Development Fund. Annual Report, 1999.

The Arab Bank Microenterprise Lending Program: The Case of the Gaza Strip. I. Hamze, 2/23/00.

The Detailed Strategic Plan to Achieve Operational Sustainability of the Al Ahli Microfinancing Company. G. Perrett, June 2000.

West Bank and the Gaza Strip. Economic Developments in the Five Years Since Oslo. The International Monetary Fund, 1999.

ANNEX V
PEOPLE MET/INTERVIEWED DURING THE COURSE OF THE ASSIGNMENT.

Mr. G. Abuyaghi, General Manager, *Al Ahli Microfinancing Company*

Mr. C. August, General Manager, *Palestinian Banking Corporation*

Mr. M. As'sad, *Massar Associates*

Mr. J. Conly, Deputy Assistant Administrator, *USAID*

Ms. M. Ellis. Director, Private Enterprise Office, *USAID*

Mr. I. Hamze, Senior Microfinance Specialist, *ISAMI*

Ms. H. Husseini, *Attorney at Law*

Mr. F. Jeroy, Senior Advisor, Private Enterprise Department, *USAID*

Ms. L. Katbeh, Legal Counsel, *Masser Associates*

Mr. J. Kattan, Chairman of the Board, *Al Ahli Microfinancing Corporation*

Mr. M. Khaled, General Manager, *FATEN.*

Mr. R. Khouri, Project Officer, *International Finance Corporation.*

Ms. B. Kominsky, Consultant with Barents. *Advisor to the Palestinian Monetary Authority.*

Mr. N. Al Masri, *Palestinian Banking Corporation*

Mr. O. McGill, Chief of Party, *Capital Markets Development Initiative*

Mr. J. Nesnas, Vice President, *Arab Bank.*

Mr. A. Pollock, Chief, Microfinance Programme, *UNRWA*

Mr. J. Whitaker, Chief of Party, *ISAMI*

Mr. J. Zeidan, Private Sector Specialist, *USAID*

ANNEX VI
THE POTENTIAL ROLE OF USAID.

Background:

VI.1). The purpose of this Appendix is to discuss why it is important that USAID be prepared to commit funds to assist a commercial bank in establishing a specialized microfinance subsidiary within the WBGS. Furthermore, various methodologies for providing such assistance are identified.

Why USAID Intervention May be Necessary:

VI.2). The reasons why USAID intervention may be necessary for the establishment of the subsidiary relate to alleviating the concerns commercial banks might have regarding establishing a specialized microfinance subsidiary. The issues most likely to cause concern to the commercial banks are identified below:

The Issue of Political Risk:

VI.3). Given the current level of unrest within WBGS, the establishment of a new microfinance unit is not recommended. Upon a return to normalcy, however, the possibilities of commencing such a venture improve considerably. Nonetheless, most commercial banks would prefer to wait until they are convinced that there will not be a relapse into another extended period of instability before making the necessary investment. This cautious approach could result in considerable delays in the establishment of the subsidiary. To encourage the commercial banks to be more aggressive in this regard, USAID would have to be prepared to commit some funding to the venture. This investment would signal that the US government has confidence in the ability of both the PA and the PMA to provide the necessary political and social stability, and that the SME market is recovering.

The Precedence of Previous Practice.

VI.4). Previous microfinance programs have been supported by external funds. The previous USAID program provided technical assistance to Arab Bank and Bank of Jordan. The ongoing IFC program provides both soft loans and technical assistance to Arab Bank, Bank of Jordan and Commercial Bank of Palestine. Furthermore, USAID has provided considerable sums of loan funds to FATEN. Potential parent commercial banks would be justified in asking why this time USAID is not prepared to commit funds to what they (the commercial bank) consider could be a risky operation. If USAID is not prepared to invest in an idea that it is sponsoring why should the commercial bank?

The Issue of Regulatory Risk:

VI.5). As noted in various sections of the paper, the PMA has not yet drafted any regulations regarding the oversight of specialized lending institutions. Moreover, since this is “unknown terrain” for the PMA, the regulations could be set in an arbitrary manner, and subject to change at short notice. While this is not considered to be a major risk, the commercial bank may not view it in that light. Hence, it may be incumbent on USAID making a certain amount of moral and financial commitment to the venture to re-assure the commercial bank that if regulatory problems do arise, USAID will have a stake in the outcome.

The Issue of Control:

VI.6). In the eyes of the parent company, the creation of a specialized microfinance subsidiary will mean that the parent company loses some of the control that it normally exercises over the daily lending operations. This could mean that the parent will hold back from making a large investment in the subsidiary, thereby minimizing its risk. Another party, such as USAID may have to provide financial assistance to the subsidiary to help alleviate that fear.

Credit Risk:

VI.7). Despite ample evidence to the contrary, many commercial bankers still view loans to the SME sector as being unduly risky. This reflects the historically conservative banking culture prevalent in the region. To overcome this culture USAID may have to provide them with financial incentives to become involved in this sector. In this regard a staff member at IFC opined that the commercial banks will not extend loans to the SME sector without funding from an external party.

The Lack of Liquidity:

VI.8). While not an issue at this time, with a return to normalcy there might be a sharp upsurge in loan demand that the banks may be hard-pressed to satisfy from their existing deposit and capital base. This could lead to a rationing of credit, to the detriment of the SME market. In order to ensure that the SME market is adequately funded, it might be necessary for loan capital to be made available to the subsidiary so that it can continue its operations.

Possible Forms of Funding that Could be Provided:

VI.9). The various forms of financial assistance that USAID could provide towards the establishment of the specialized subsidiary include the following:

Funding the Training of Field Agents and/or Supervisors:

VI.10). The banking and financial skills necessary to successfully manage a microfinance portfolio are quite different to those required for a commercial bank loan portfolio. Consequently, most successful microfinance providers provide special training to their staff, in particular to their field agents and loan supervisors. Funding the cost of this training for the staff of the subsidiary would be an ideal form of technical assistance that USAID could provide. Furthermore, with the successful microfinance training available through the Institute of Banking Studies in Jordan, it will be relatively easy to organize and implement.

Providing Technical Assistance for the Preparation of Operations, Procedures and Credit Manuals:

VI.11). In order to ensure the smooth operation of the subsidiary, specialized operational manuals will have to be prepared, or the parent bank’s manuals substantially revised, for usage by the staff of the subsidiary. Given the substantial differences in the mode of operations between commercial banks and MFIs, the subsidiary will probably need to hire consultants to assist in their preparation. USAID could consider financing the cost of these consultants.

Fund the Development of a MIS System:

VI.12). One of the major challenges faced by microfinance lenders is the design, installation and operation of a reliable, user- friendly MIS system. Whether the MIS is adapted from existing systems, or is tailor-made for the individual lender, they tend to be expensive and time consuming. The funding of the design, development, installation and documentation of an effective MIS system would be a valuable contribution, regardless of whether a new system is specially designed for the system, or an existing system is adapted.

Donor Funding of the Salaries of the Field Agents and/or the Supervisors During the Start-Up Phase of Operations:

VI.13). Salary costs of the microfinance lender normally represent the major operating expense of a microfinance lender. These costs are particularly onerous during the start-up phase of the microfinance lender, when no loans have been extended and, hence, no income is being generated. During this period the field staff are undergoing training. USAID may consider funding the salaries and benefits of the staff during the start-up phase, while they are undergoing training and are not generating any revenue.

Direct Funding for the Loan Portfolio:

VI.14). The major asset of any lending institution is its loan portfolio. Furthermore, the loan portfolio usually is the asset that is most difficult to finance, due to the factors of credit risk, capital leverage constraints, and maturity gapping. Consequently, many microfinance lenders have difficulty raising loan portfolio funding from investors or donors, either in the form of equity or loans. In order to encourage a commercial bank to invest in a specialized subsidiary, while limiting the said bank's risk exposure, USAID may have to consider providing portfolio funding to ensure that the subsidiary is not under-capitalized. It appears that the rules and regulations of USAID make it difficult, if not impossible, for USAID to take an equity position in microfinance lenders. Any funding for the loan portfolio, therefore, would have to take the form of a grant. This grant funding would have to be channeled through a separate entity, which would have oversight responsibility to protect USAID's interests in the subsidiary. Moreover, the terms and conditions of this grant funding would have to contain specific agreements as to the sharing of any loan losses incurred, thereby ensuring that the microfinance lender maintains high due diligence standards in managing the loan portfolio. A further incentive for the subsidiary and its parent to act responsibly regarding the grant funds, is that this grant loan portfolio funding will form part of the permanent basis of the subsidiary's capital.

The Establishment of a Loan Guarantee Fund:

VI.15). An alternative to direct funding of the loan portfolio, would be for USAID to provide loan guarantees to other lenders to the subsidiary when its financing needs begin to exceed the parent commercial bank's ability, or willingness, to provide further financing. Under this approach USAID would co-guarantee the external lender (possibly through the use of a Stand-By Letter of Credit) against any default by the borrowing subsidiary. Again, the parent commercial bank would have to co-guarantee the losses to ensure that its subsidiary would exercise continued due diligence in managing the loan portfolio. This approach would require a more intense level of oversight than direct funding of the loan portfolio approach, but would require a smaller outlay of funds.

Financing the Initial Capital Expenditure Purchases:

VI.16). Normally the initial capital assets required to establish the microfinance lender are funded from the subscribed capital of the MFI. This reduces the amount of capital available to fund the loan portfolio. Instead of providing funding to the MFI for financing the loan portfolio, or to purchase an equity position, an alternative approach is to finance the necessary capital assets, such as office furniture and fittings, computer software/hardware and motor vehicles.

Financing the Initial Market Awareness Campaign:

VI.17). The suggested implementation plan calls for a market awareness campaign to be launched at least one month before loan applications are accepted, so as to create "brand awareness" for the subsidiary. This advertising campaign would be mounted through the television, radio and print media, as well as by pamphlets. This campaign will be extremely important to the successful launch of the subsidiary, and will require the outlay of large sums of money is lump sum payments. Given that it will be basically a one-time expense, and is incurred during the start-up stage of operations, makes it an ideal candidate for external funding.

A Block Grant Approach:

VI.18). Rather than provide funding for a specific purpose, USAID may wish to consider providing a block grant to the subsidiary. This grant would be used at the discretion of the management of the subsidiary, either for the initial capitalization of the subsidiary, to cover operating costs, or to finance the loan portfolio. While this would give the subsidiary greater flexibility in managing its affairs, it does imply a certain loss of control by USAID over the use of the funds.

Non-Financial Assistance:

VI.19). As an alternative to, or in conjunction with, financial support; USAID can provide its good offices to help in the establishment and initial operations of the subsidiary. This assistance can take the form of assisting in negotiations with the PMA over the drafting of the regulatory requirements for specialized lending institutions, assisting in the registration of the subsidiary with the MOET, and having the requisite laws necessary to protect creditors rights (Basic Law, Independence of the Judiciary Law, etc) passed, and signed by the President.

The Methodologies for Disbursing Financial Assistance:

VI.20). The method of disbursement to be used will depend on the level of oversight and control USAID wishes to exercise over the activities of the subsidiary.

VI.21). If the strategy is to have as little involvement as possible, the agreed upon funding could either be disbursed as a lump sum at the commencement of the venture, or according to a pre-arranged timetable regardless of the performance of the subsidiary.

VI.22). On the other hand, if USAID prefers to exercise closer control over the venture, funding should be disbursed in installments. Disbursements by installments also should be adopted if USAID wants to ensure that the subsidiary is allowed to operate for a sufficient period of time to prove the viability or otherwise of the concept. Disbursements by installments can operate on either a reimbursement basis (refunding outlays made on behalf of the subsidiary) or made against requests for disbursements submitted by the subsidiary.   Whichever method is adopted will depend to a great extent on the level of trust built up with USAID and the parent commercial bank and the subsidiary.