MICROFINANCE IN TIMES OF TROUBLE
SOME THOUGHTS FROM THE WEST BANK AND GAZA

Submitted to:

Chemonics International – Initiative for Sustainable and Accessible Microfinance Industry (ISAMI) Project

and

The United States Agency for International Development (USAID) / West Bank and Gaza Mission

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March 2002

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INTRODUCTION AND SCOPE OF THIS REPORT

This report reflects on the experiences of myself, Dave Larson, in a very brief consultancy to ISAMI (Initiative for Sustainable and Accessible Microfinance Industry), a USAID-funded project of Chemonics International. The purpose of ISAMI is to encourage and support the development of a microfinance industry in the West Bank and Gaza.

The in-country portion of the consultancy took place on 17-20 February, 2002. It included meetings with four microfinance providers in the West Bank and discussions with other related parties (including ISAMI staff). It culminated in the conference "Microfinance in Times of Trouble." Unfortunately, military operations the night before and morning of the conference considerably limited attendance and reduced the duration of the discussions.

The meetings were held with two NGO-MFIs (Non-Government Organization – Microfinance Institutions) and with two commercial banks that have microfinance windows:

NGO-MFIs

- Ms. Jane Giacaman, Microfinance Officer, UNRWA
- Mr. Mohammed Khaled, Executive Director, FATEN

Commercial Banks

- Ms. Susan Khoury, Credit Manager, Bank of Jordan
- Mr. Joseph Nesnas, Vice President, Institutional and Private Banking, Arab Bank

(Due to problems related to the military operations, Mr. Firas Nejjad gave Mr. Nesnas's presentation at the conference itself).

As important as it is to tell what a report "is", it is equally important to clarify what is "is not." This report is not an exhaustive, thorough, in-depth study of the microfinance industry in the West Bank & Gaza, nor is it even an *in-depth* look at the issues related to the "Times of Trouble", their effect on microfinance, and the responses of MFIs. The scope of the consultancy simply did not allow for such.

I am also deeply concerned about the tendency of some "external experts" to fly into a new situation and make bold, sweeping pronouncements after very limited exposure to the difficulties, issues, and players in the context. Thus, I would like to humbly offer this not so much as a formal "report" but as merely a collection of some initial thoughts, impressions, observations, and "musings". Secondly, to emphasize this, I have used and will continue to use the first person singular pronoun, rather than "the consultant" and/or other impersonal terms. I will also strive to emphasize readability and quality over quantity in the writing. I find that shorter, punchier reports generally make greater contributions to understanding and action than do long, dense ones.

Finally, please allow me to thank and recognize all Chemonics and ISAMI staff and other parties for their help in this assignment, especially Mr. Guy Hengeller, Assistant Project Administrator, Middle East Region, Chemonics, Mr. James Whitaker, Chief of Party, ISAMI, Mr. Imad Hamze, Hamze, Senior Microfinance Specialist, ISAMI, and Mr. Johny Zeidan, Private Sector Specialist, USAID/West Bank and Gaza Mission.

ABBREVIATIONS AND ACRONYMS

ISAMI	Initiative for a Sustainable and Accessible Microfinance Industry
MFI	Microfinance Institution
MFP	Microfinance Program
NGO	Non-Government Organization
UNRWA	United Nations Relief and Works Agency
USAID	United States Agency for International Development
WB/G	West Bank and Gaza

EXECUTIVE SUMMARY

During the 18 months of the current *intifadah,* great damage has been done to the microfinance industry in the West Bank and Gaza. Nevertheless, microfinance practitioners have responded with courage, commitment, and innovation, and in doing so have achieved a remarkable degree of recovery. Practitioners have adjusted, found ways to care for and motivate their staff, and developed a good balance of toughness and flexibility on the all-important issue of portfolio quality. Recovery appears to have been greatest for those for whom social mission is equally important as financial performance. These players have shown an enormous will to serve their clients, and in doing so have found ways to adjust to some of the most difficult circumstances that have ever faced a microfinance industry.

Significant challenges remain, especially if the conflict worsens or is not resolved by at least the medium-term. Among these challenges is the growing incidence of bad practices employed by some practitioners under the encouragement of a few donors. Nevertheless, the fact that those practitioners who follow sound practices have had stable performance for roughly the past year of the *intifadah* gives one hope that they will be able to respond even to new challenges that come.

INITIAL THOUGHTS, IMPRESSIONS, OBSERVATIONS AND MUSINGS

As I reflect on my brief time in the West Bank & Gaza (WB/G), the following stand out to me as impressions and thoughts that I will remember. I hope that some of them will be of value to the readers:

1. **Where There's a Will, There's a Way.**

My strongest, most lasting impressions occurred during my first meeting (with Jane Giacaman of UNRWA, the United Nations Works and Relief Agency) and were confirmed later with others such as FATEN. Namely, I was greatly struck with the way in which UNRWA, FATEN and others found ways to adjust even to very difficult conditions. This seemed to be especially true of those organizations that were devoted solely to microfinance. For them, serving low-income microentrepreneurs through microfinance is their <u>mission</u>. It is their sole *raison d'etre.*

Given this, when faced with the myriad difficulties of the *intifadah* and Israel's response (herein referred to jointly as "the *intifadah*"), they didn't give up. They exhibited the will, even the tenacity, to find ways to accomplish their mission. Because they had the *will*, they found *ways* to adjust.

In UNRWA's case, they have even expanded, at least geographically. UNRWA has opened a new branch, in Hebron. UNRWA plans to reduce its vulnerability further and diversify its portfolio by expanding into Jordan and Syria. With branches in these countries, UNRWA seeks to be a mulitinational MFI with a more diversified, less disaster-subject, clientele.

2. **"Times of Opportunity."**

Another way of putting this "will…way" idea is that those MF Programs ("MFP's" – including NGO MFIs and Commercial Banks with MF windows) that appear to have best weathered the storm of the *intifadah* appear to be those who have seen it not merely as a time of *trouble* but as a time of *opportunity*. They've seen it as an opportunity to accomplish what MF is all about – helping low-income microentrepreneurs to help themselves.

MFPs strive for sustainability, effectiveness, and efficiency. They seek to take the best of the "business world" and achieve high financial performance. At the same time, MFPs have a social mission. Those who have done best during the *intifadah* appear to be those who took seriously both components of their mission – business and social, and, more importantly, who used the social mission to motivate them to do well on the business side.

This may account for the rather optimistic, upbeat tone of some of the MFPs with whom I met. From the reading that I'd done before arriving, I expected an atmosphere of despair, gloom, and hopelessness. Instead, I found one of relative optimism. Ms. Giacaman talked about the *intifadah* in the past tense. She did so not because it is over, but because UNRWA and others have *adjusted* to it. Because of these adjustments, many of the effects, at least in terms of *worsening* indicators, seem to be over.

This optimism and forwardness-of-looking is not due to naïve, pie-in-the-sky thinking. MF practitioners realize how grim things are. However, they choose to focus on the positive differences that they are making, rather than on the negatives. This is especially true for those who are strongly committed to their social missions.

3. **Damage has been done.**

At the same time, the MF industry in WB/G has suffered. Storms happen. MFIs need to prepare for storms. Preparation is best done by building solid foundations before the storms hit. Yet, no matter how well one prepares, severe storms are likely to do damage. This has certainly been the case in the WB/G. Although much can be said about the spirit and will of several MFPs in the face of adversity, one cannot ignore the damage done. These include, but are not limited to:

- **Outreach and Sustainability Setbacks**

  MF has two primary goals: 1. Outreach (making an impact in the lives of many people); and 2. Sustainability. The latter is actually the key to the former. Sustainable, permanent institutions are able to achieve outreach over a long period. They are able to "pay for themselves," and thus be independent of donor vicissitudes).

  During the *intifadah*, outreach and sustainability have suffered. E.g., the Bank of Jordan's MF portfolio has dropped by roughly 60%, from about $2M to $800K, and its number of clients served from 1,460 to 657. UNRWA's operational self-sufficiency has fallen from 140%+ to 80%+.

  Why? In sum, costs are up and revenue is down. Staff productivity has plummeted, with staff having to spend far more time just getting around and collecting loans, not making them. These and other factors have significantly raised the cost of business – the cost of doing microfinance (MF).

  Meanwhile, revenue is down. This is due primarily to decreased demand (see below). Added together, increased costs and decreased revenues have set back outreach and institutional financial sustainability by years.

- **Opportunity Costs**

  As emphasized by Mohammed Khaled, while FATEN and some other MFPs have recovered to somewhat close to their pre-*intifadah* levels in several key areas, they have also suffered great opportunity costs in terms of lost time for growth, development, and consolidation. FATEN's portfolio and number of clients served stands at only 50% of previous projections.

Likewise, having to focus on fundamental, basic issues of lending has held back the MF industry from moving forward on product development and in other ways to improve and expand its services. As Khaled stated:

> *Our MF experience hasn't been as "deep" as in other countries, where they're discussing and experimenting with more advanced things like microinsurance, poverty targeting, etc…. We've been prohibited from advancing qualitatively, not just quantitatively. We've been held back from moving into more sophisticated, potentially higher impact, areas of MF.*

- **Bad Practices**

As often happens during times of trouble, some players have lost sight of or chosen to ignore the business part of MF and have instead focused solely on the social mission. While this is understandable, it is regrettable and even ironic in that ultimately the social mission is damaged when the business mission is ignored. Dead institutions serve no one.

Donors, practitioners, and others who encourage or employ practices such as no-interest loans ultimately hurt their clients, other institutions, and thus, indirectly, other clients. This violates the hypocratic oath of development – to first do no harm.

While this appears not to have been as great a problem in the WB/G as in other contexts, it may seriously threaten sustainable microfinance. It was reported that some donors are offering millions of dollars to any MFP that will agree to give interest-free loans. This could greatly hurt not only MFPs but ultimately clients who need long-term access to MF services. What is bad for an institution is bad for clients.

4. **Significantly Decreased Demand**.

As mentioned above, revenue and sustainability have dropped greatly due to decreased loan demand. Some of the greatest damage to the industry has occurred due to the huge drop-off in business activity in general, and, consequently, in microenterprise. The experience of the WB/G appears to be somewhat unique in this way. Many other settings that have experienced conflict or other disasters have usually seen *increased* MF demand.

In Indonesia, for example, the microfinance division of BRI actually blossomed following the Asian Economic Crisis of the late 1990s. While the over divisions of

BRI tanked, MF grew – both quantitatively and in terms of profitability. In short, individuals flocked to the informal economy as their formal sector jobs disappeared.

The only country that in my knowledge has had experiences that seem to mirror those of the WB/G is El Salvador - in the months of continuing, frequent earthquake activity and for a while thereafter. During that time, demand for the goods and services of microentrepreneurs dropped, as people "hunkered down" in their homes, waiting for the quakes to finally stop. To use the "storms" metaphor – not much business is done during a severe storm.

Likewise, while hundreds of thousands of Palestinians have been thrown into the informal sector as a result of the closures and other measures, this has not sufficiently increased the demand for microfinance to make up for the decreases that have occurred otherwise. Why? In short, it appears that demand for *all* goods and services has dropped so much that the informal sector of the economy simply does not have the capacity to absorb the new workers.

5. **Adjustments?**

The first question that most microfinance practitioners ask when hit by disaster is "What should we do?" What this often means is "What, if anything, should we do *differently?*"

Again, this consultancy and its report are not exhaustive treatments of that subject. However, it *appears* that the following may be a few "lessons learned" from the WB/G about how MFPs can respond, especially in terms of making adjustments:

- **Be Careful in Applying External Advice to your Context**

  While the MF industry world-wide has learned a lot in recent years about how to respond to disasters, a lot that remains to be learned. One lesson that is clear to me is that we must be careful about "one size fits all" advice. The contexts in which disasters occur and the nature of the disasters themselves vary too greatly for the lessons of a disaster in one setting to apply to all others.

  E.g., some observers concluded after the 1998 severe flooding in Bangladesh that disasters would create liquidity problems for MFIs. Why? Because it happened there, and because the arguments for it happening elsewhere made sense. In Bangladesh and elsewhere, 1) loan repayment rates dropped; 2) clients needed new, emergency loans; and 3) clients withdrew savings. This combination of less money "in" and more money "out" caused liquidity crunches for MFIs.

  In sharp contrast, in El Salvador, while repayment rates dropped slightly, 1) there was little demand for new loans – emergency ones or even those for "new cycles"; and 2) many clients even prepaid loans that they'd just taken out before the quakes. They realized that there was not enough demand for their goods and services, so they didn't want to carry the debt.

In short, microentrepreneurs recognized the decreased demand for their services and subsequently lowered their demand for MF. This caused a liquidity *surplus* for MFIs, not a liquidity crunch.

The WB/G received other inappropriate advice from. FATEN's initial reaction top the *Intifadah* provides an example. Quoting Mr. Khaled:

> *We made a major mistake in the beginning. We read the writings of some experts who said that MF shouldn't be done in times of conflict, so we totally stopped disbursing for a while. This hurt us and our clients. It was a major error.*
>
> *It damaged the primary incentive that clients have for repaying – the opportunity to get additional financing. Without that, repayment plummeted. After a while, we realized that this was a mistake, resumed lending, and repayment recovered.*

- **Be Prepared to Adjust Frequently**

Adjustments may not be a one-time thing. Frequent adjustments may need to be made as the situation changes. As Susan Khoury said, "We've constantly fire-fighting – having to respond to the changing circumstances."

- **Increase Business and Sector Analysis**

Often, with group-based microfinance methodologies and even with much individual lending loan officers do not do a great deal of business analysis when considering loan applications. That function is "delegated" to the group members or, with individual lending, the clients' guarantors. Since this type of lending leans heavily on guarantees and on client character, it is felt that fellow members and/or guarantors are best suited to determine the credit worthiness of an individual and her business.

In contrast, MFPs in the WB/G found that they have needed, during the *intifadah*, to get much more involved in this level of decision-making – both with group-based and individual lending. This has involved more in-depth analysis of the business itself, as well as greater understanding of the sector (tourism, trade, garment-making, etc.). Clearly, some sectors were hurt much more than others.

- **Train Staff in Business Analysis and/or Hire Additional Staff for Such**

To accomplish the above, loan officers may need more training in business analysis than they may have received before. In some cases, additional staff may need to be hired – some loan officers who do well in a highly-structured, minimalist group-based lending methodology may not have the skills, or even the "trainability" to develop new skills, for more advanced business analysis.

- **Be Tough…but Flexible**

MF in WB/G may have suffered more from the conflict that has afflicted it than have the MF industries in almost any other setting. Despite this, WB/G MFPs have demonstrated once again that even in very challenging environments, credit discipline is not only necessary, but it can "work." That is, with proper support, encouragement, incentives, and the right amount of "pressure," even very poor microentrepreneurs hit by disasters can and do fulfill their loan commitments.

To some this may sound harsh. However, it is, in the long-run, best not only for the MFPs, but for the clients themselves, since this will ensure that they and other clients will continue to receive high-quality, sustainable MF services.

A primary way of achieving this has been to beef up collection departments. UNRWA, for example, found that it could no longer rely solely on legal enforcement – on the police and courts. The police, especially, were too busy trying not to be attacked. Thus, UNRWA developed its own collection department, which includes lawyers and collectors.

This also gives UNRWA the ability to respond quickly to repayment problems (something that it must pay special attention to, given UNRWA's perception by some as being a "charity"). Thus, according to Ms. Giacaman, "Before, we were a bit lax on repayment. If a loan officer said that a client needed a few more days to pay, we'd automatically give it. Now, in such a case, the branch manager would get involved right away – at least to verify the loan officer's recommendation."

At the same time, some flexibility is required to achieve good repayment. The MFPs interviewed showed this in several ways, such as in:

- ✓ Restructuring. MFPs stretched out loan durations, often without enforcing late-payment penalties, for clients who had loans outstanding when the *intifadah* began. (Note, however, that most did *not* do this for loans disbursed *after* the *intifadah* commenced).

- ✓ Reduced Loan Sizes. Some of this came naturally, as many clients decided on their own to borrow less. However, in other cases the MFPs decided, after analyzing businesses and sectors, to lower their risk by making smaller loans to many clients.

- ✓ Usage of Recommendations from Good Clients. Relying perhaps more than ever before on the recommendations of good clients. UNRWA has found that using the opinions of its good clients is the best way to judge the credit-worthiness of new applications.

- **Remember Staff Needs**

While focusing on clients and on how they have been affected by the disaster, MFPs in WB/G also recognized the greatly demoralizing effect that the killings, harassment, and other trauma had on their own staff. MFP responded in a variety of ways, some very practical (equipping staff with mobiles and flak jackets to improve their safety), and some psychological (see "loans…stones", below).

Responses included adjusting compensation schemes. E.g., formerly in the Arab Bank, loan officers earned about half of their compensation through fixed bases and the other half if they met incentives. However, with quantitative and qualitative portfolio measurements dropping due to circumstances beyond the LO's control, the Bank had to change the incentives to be fair to the staff and to motivate staff to address the Bank's new needs. E.g., staff are now rewarded partly for the number of bad loans that they made good.

6. **"Loans, Not Stones." Motivating staff**

A major challenge facing MF providers has been how to motivate staff who have had to work under such difficult conditions. Mr. Khaled of FATEN described one method he used:

> *I've…put our work in political perspective. Israel wants to destroy everything Palestinian, including our institutions. FATEN is a Palestinian institution...Thus, our part in the struggle is to do our business. We're too old to throw stones, but we can contribute through loans. The way we fight is to save our institution and to help our clients save their businesses and provide for their families.*

7. **The Role of Commercial Banks?**

The contrast between the experiences of the WB/G NGO MFIs and commercial banks may contribute to the debate on the role of commercial banking in microfinance. As mentioned above, the NGO MFIs seemed to respond better to the challenges of the *intifadah*, perhaps largely because their microfinance portfolios weren't merely *part* of their work – they were *all* of such. As Mr. Khaled said: "We had to find a way to work within (the *intifadah*). We're not like (a commercial bank), for which MF is a minor part of its portfolio. MF is our only function. We had no choice."

It might be too strong to conclude that commercial banks may do well in microfinance in good times but abandon their efforts in difficult times. Nevertheless, at the very least one may conclude that MF done by commercial banks might best respond to troubling times when it is done by subsidiaries or other structures that are fully-dedicated to MF. When commercial banks do microfinance merely through departments or "windows", there may be a tendency to give up more easily when the going gets tough.

If one is at sea with a fleet of boats when a storm hits, it may be tempting to jump onto the biggest, strongest boat and abandon the smallest one. However, if one is at sea in one boat only and none are nearby, when a storm hits one will make every effort to get that boat to shore.

Microfinance-focused units, whether they are in NGOs or subsidiaries of commercial banks, may be motivated to find solutions to the myriad and complex types of problems that arise when the going gets tough.

8. **Need for a Credit Bureau**

Finally, while most of the above has been descriptive rather than prescriptive, please allow me to make at least one humble recommendation from my brief time in WB/G. Based on my experience elsewhere, I'd highly recommend that the industry develop a credit bureau that will share client information with all MFPs. It appears that credit bureaus are especially needed in troubling times. During such, some clients may tend to do things that they wouldn't normally do – morally justifying less-than-honest actions by blaming the situation. For this and other reasons, credit bureaus can help MFPs avoid such clients and can strengthen client repayment motivation due to the need to keep a clean credit history.