FIELD Report No. 4

Study on Options, Management and Enforcement of Collateral for Microfinance loans in the West Bank and Gaza Strip

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Table of Contents

List of Acronyms and Abbreviations

ACAD:	Arab Center for Agricultural Development
AED:	Academy for Educational Development
ANERA:	American Near East Refugee Aid
ASALA:	The Palestinian Business Women Association
JD:	Jordanian Dinar
IFC:	International Finance Corporation
FGD:	Focus group discussion
MEDA:	Mennonite Economic Development Associates
MFP:	Microfinance Provider
MMD:	Microfinance and Microenterprise Department (of UNRWA)
NIS:	New Israeli Shekel
PA:	Palestinian Authority
PDF:	Palestinian Development Fund
PMA:	Palestinian Monetary Authority
PARC:	Palestinian Agriculture Relief Committee
PNSMF:	Palestinian Network for Small and Microfinance
SMART:	Small and Microfinance Assistance for Recovery and Transition Program
UNRWA:	United Nations Relief and Works Agency for Palestine Refugees in the Near East
USAID:	United States Agency for International Development
WBG:	West Bank and Gaza

Executive Summary

This study was commissioned by the Small and Microfinance Assistance for Recovery and Transition (SMART) program of the Academy for Educational Development (AED) and was funded by United States Agency for International Development (USAID). SMART is a two-year program designed to preserve the microfinance institutional infrastructure in the West Bank and Gaza (WBG) and assist microfinance intermediaries develop and adopt effective strategies and management practices during the present emergency in order to lay the foundation for a transition to sustainable growth. To assist microfinance practitioners (MFPs) in adapting products and delivery mechanisms for the protracted economic crisis in the WBG, SMART decided to commission a Study on Options, Management and Enforcement of Collateral for Microfinance loans in the WBG. The study is the first of its kind in that it provides a detailed review of collateral options and related management and legal enforcement issues in the West Bank and Gaza.

Methodology

The findings presented in this report are based on two primary data collection methods: in-depth individual interviews and focus group discussions (FGD). While individual interviews were conducted with key stakeholders from the government, private sector, international development agencies and industry support organizations, FGDs were conducted with clients, non-clients and MFPs. The interviews and FGDs were conducted in Ramallah, Jerusalem and via video conferencing facilities with Gaza. In addition, the analysis was enriched with findings from a literature review and secondary data (such as evaluation reports, appraisal documents, performance data from the network, and alike). Annex 2 provides the list of organizations and people interviewed. Annex 10 provides a list of references and an annotated bibliography of documents used in the study.

This report presents an analysis of the findings from the literature review, documents, interviews and FGDs, with recommendations for the expansion and management of collateral options for micro loans in West Bank and Gaza.

Findings

Achieving statehood has been a primary goal for Palestinians for generations. This quest has a long and turbulent history, marked by a track record of negotiations followed by outbursts of unrest and instability. The complexities involved in reaching a lasting peace settlement between the Palestinians and Israelis have become even more encumbered with the recent friction between the two leading Palestinian factions, Fatah and Hamas, the latter being the right-wing party elected to power in January 2006. With llamas seizing power in the Gaza Strip in June 2007, Gaza and the West Bank effectively operate as separate entities today. This situation has left the territories of the West Bank and Gaza in a state of political and economic uncertainty.

The Basic Law of 2002 states that free market principles operate in the West Bank and Gaza

Strip. The Palestinian Authority (PA) has long recognized the importance of a strong economy led by the private sector in reaching the overarching goals of nation building. A vibrant private sector is the centerpiece of economic activity needed for job creation and poverty reduction. In an effort to promote sustainable peace in the troubled region, private investment is seen as an important ingredient. A continued reform effort aimed at attracting investment has been underway since the signing of the 1993 Oslo Agreement. Despite these efforts, however, it clearly remains difficult for businesses to effectively function under such a high degree of uncertainty and instability.

The Israeli occupation continues to underlie all aspects of Palestinian lives, afflicting business operations due to the heavily restrictions placed on the movement of goods and people in and out of the West Bank and the Gaza Strip. Even during times of relative stability between the Palestinians and Israelis, daily operational practices have been complex and costly. The political set backs have hindered the advancement of legal policies and rule of law reform. They have also affected the reform at the public governance level. Economic hardship has increased and the prospects for economic recovery and domestic investment are not easily foreseeable in the immediate future.

The Palestinian Territories represent a developing market for financial services. The Palestinian economy is characterized by the prevalence of small and medium enterprises. The business sector experienced limited growth over the past seven years as the internal political context has become increasing complex. This, coupled with the severe closure policy, has increasingly limited employment opportunities with the traditionally reliable and stable labor market in Israel no longer offering viable opportunities for Palestinians. Smaller businesses faced hardships because the business cycle slowed down. People turned to micro business activities to generate income and cope with job losses, including the production of handicrafts (ceramics, glassware, olive wood), traditional embroidery, sewing, beauty shops, barbers/hairdressers, butchers, computer services and mechanics. Start up micro businesses have been unable to present the track record required for borrowing from banks and thus turned to family, friends and to a lesser extent to microfinance providers hoping to meet their lending criteria.

The Palestinian microfinance sector has shown initial tenacity in responding to economic challenges during the course of the second *Intifada.* The sector as a whole experienced a 30% decrease in the number of active clients and loan portfolio outstanding during 2002 as a result of economic disruption. By the end of 2005, the sector had recovered the ground it lost and maintained a steady a steady path of growth. However, 2006 proved to be a disastrous year for WBG microfinance, with Portfolio at Risk (PAR) ratios of many Palestinian microfinance providers (MFPs) spiking and revenue falling to unsustainable levels.

MFPs need to develop effective loan recovery strategies to retain good clients and lower their portfolio at risk. They also need to develop and roll out new products appropriate to the protracted economic crisis, adopt appropriate policies and maintain trained staff to the extent possible. One aspect which is particularly important to the adaptation of new products is the usage of collateral for microloans.

Recommendations

Overall, the study finds that while MFPs are open to a wider range of collateral options, effective use of innovative collateral options is limited primarily by legal and enforcement challenges. In addition, MFPs are not fully informed of potential collateral options and their successful application. Also, there is room for improving the credit risk mitigation techniques to be more applicable in the context of WBG, including more importance being placed on character and capacity assessment (as opposed to collateral) and the proper implementation of group lending methodology as a collateral substitute. Moreover, there is great potential for introducing linkage models (where receivables are used as collateral) and leasing (where the leased asset is used as collateral). On a positive note, key stakeholders, MFPs, clients and non-clients interviewed during the study are willing and open to experiment with collateral options beyond what they currently accept, given improvements in the legal environment and enforcement mechanisms. It is critical for all stakeholders, including the MFPs themselves, their Network, international organizations, government and the private sector, to take concerted effort to achieve these improvements. In summary, this study recommends expansion and enabling of broader collateral options at all levels of the financial system:

Recommendations at Retail Level for Microfinance Providers:

1. Expanding the pool of assets accepted as collateral
2. Introducing new financial products and services
3. Improving the implementation of group lending (group guarantee) methodology
4. Increasing use of notary deeds

Recommendations at Meso Level for Industry Stakeholders:

1. Building the capacity of MFPs to better manage credit risk
2. Introducing a political risk insurance
3. Educating judges and judiciary personnel on collateral enforcement options
4. Establishing a legal unit and legal clinics for MFPs and Clients
5. Advocating for the establishment of a special police unit dedicated to contract enforcement
6. Advocating adoption of the draft secured transactions law
7. Enhancing credit information (through the PMA credit reference bureau)

Recommendations at Macro Level for Policy makers and Regulatory Authorities:

1. Establishing an official registry of movable assets to strengthen lenders' collateral options
2. Enhancing the legal framework and standards for business assets as enforceable collateral
3. Establishing self help principles within the legal framework
4. Waiving legal defence clauses
5. Advocating the use of possessory interests in movables and "limited assignment" options
6. Inclusion of the non-profit company registration option in the draft Companies Law.

1. International Microfinance Practice

1.1. Credit risk management

Taking credit risk is part and parcel of financial intermediation, and the effective management of credit risk by financial intermediaries is critical to institutional viability and sustained growth. Failure to control risks, especially credit risk, can lead to insolvency. Adequately screening and analyzing credit risk in financial institutions is therefore critical for their survival and growth.

In mainstream financial intermediation, there are two broad means of evaluating creditworthiness: *appraisal of repayment capacity*, and *asset-backed lending*[1]. The former approach focuses on investigating the integrity, moral character, management ability, and debt paying capacity of a potential borrower either by staff or statistical models (e.g. track records) or both, while the latter focuses on the quality and quantity of assets that can be pledged as collateral and quickly liquidated in the event of a default.

Repayment Capacity

The principal means that a financial institution uses to control credit risk is a solid credit evaluation done by a trained professional. The classic business credit analysis involves a highly labor intensive process consisting of many steps, as listed in Table 1[2]:

Table 1

Credit Analysis Process Flow

- Management Analysis: Competence, Integrity
- Financial Analysis: Balance Sheet and Cash Flow Analysis and projections
- Sector Analysis: Position in Industry, Price Trends, Competition, Suppliers, Labor Situation, Transport and Marketing Issues, Importance of Quality and Differentiation
- Qualitative Factors, e.g. Environmental Due Diligence
- Financial Simulations: Stress Testing, Breakeven Analysis
- Risk Rating/Legal Opinion
- Loan Administration: Set up, Funding Schedule, Entry into Data Management System
- Negotiations/ Credit Approval
- Loan Documentation/Closing

This classic credit analysis hinges on the subjective judgments of trained personnel. Credit officers are turned into experts over time, gaining authority as they acquire experience and demonstrate skill.

As business lending has expanded from the acquisition of fixed assets to financing working capital, the focus of analysis has shifted from the static balance sheet to cash flow, a set of financial ratios, and a consideration of the competitiveness of the borrowing firm. The analyst's main concern is

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[1] Wenner, M., Navajas, S., Trivelli, S. and Tarazona, A. (2007). Managing credit risk in rural financial institutions in Latin America. Inter-American Development Bank, Washington, DC.

[2] *Ibid.*

how the injection of capital will be used, how competitive the borrower is within the sector or industry in question, how sensible the pursued business strategy is, how good the management team is in delivering results, and, ultimately, if the borrower will generate sufficient revenue to service the acquired new debt while confronting the hiccups and shocks that are likely to occur during the course of conducting business. To aid the analysis, the credit officer usually employs a set of standard and specialized industry-specific ratios that are used to compare the potential borrower to industry benchmarks.

Expert-based credit risk analysis methodologies work, but they can also be problematic and fail from time to time due a number of reasons: poor selection of analysts, poor training, failure to follow agreed upon procedures, overly bureaucratic institutional structures wherein the sense of individual responsibility of each analyst is diluted, and natural tendencies to over-concentrate the portfolio. Over time, institutions tend to develop expertise in analyzing creditworthiness in just a few sectors and to expand rapidly in "boom times." When systematic shocks occur in the overexposed sectors, the portion of the portfolio that is non-performing can worsen unless the lending institution can obtain credit insurance or securitize its portfolio and thereby transfer its risk of over-concentration to another party.

Asset-backed Evaluation

Asset-backed lending has been around for centuries. Commercial finance companies pioneered these techniques in the 1950s in the United States and commercial banks entered the market soon thereafter. In the last 50 years, it has expanded tremendously in developed countries. Small and mid-sized companies and farmers generally do not own sufficient titled property that can be pledged to obtain large loans. The use of warehouse receipts, inventories, and receivables as collateral to secure loans emerged as alternatives to the typical land title or property.

Asset-backed lending places a premium on valuing and understanding assets and their resale value and markets. Nonetheless, heavy reliance on asset backed financing has three attendant risks: collateral illiquidity, collateral depreciation, and legal risks. The longer it takes to liquidate pledged assets, the worse off the lender will be. Likewise, the lender loses if collateral or pledged inventory suddenly loses market value, deteriorates in storage, or is damaged. Lastly, because asset-based financing requires complex documentation, public findings, strict compliance with commercial codes, and certain borrower impositions, legal errors can prove to be very costly to the lender. Asset-backed lending tends to work where there are well-defined property rights, uniform commercial codes for all jurisdictions and functioning property registries and court systems.

In developing countries, asset-backed credit evaluation approaches tend to be overly reliant on land and immovable property (real estate) as security. To a lesser extent, liens are also placed on standing crops, livestock, and equipment. The use of inventory and receivables is rather underdeveloped and represents a frontier for developing nations.

Microfinance Credit Risk Mitigation

Good practice microfinance worldwide have developed as an effective method of providing financial services to poor households and their microenterprises which often do not have access to conventional banking primarily due to lack of collateral. In the case of micro loans, the issue of credit risk is of even of greater concern because of the higher levels of perceived risks resulting from some of the characteristics of micro borrowers and the conditions in which they find themselves. Microcredit has been developed as a provision of small amounts of loans over relatively short periods of time to this same target group, typically using alternative means of collateralizing the loans (collateral substitution), such as social trust bonds.

As a way of mitigating risk with micro borrowers who are unable to provide conventional collateral, microfinance providers around the world have adopted a good practice credit risk analysis technique.

The traditional factors considered in microloan analysis are the 5 C's: **Character, Capacity, Capital, Collateral** and **Conditions.** However, for the micro-borrower with very little collateral and assets, the first two are the key factors.

Table 2: What is important in micro-enterprise loan analysis?

IMPORTANT CONSIDERATIONS IN LOAN ANALYSIS[3]		
Key Factors	**Issues**	**What to Look For**
Character	Personal information about the owner and family	· Honesty and integrity · Family situation · Ability to manage a business · Changes in business/family assets · Reputation in community · Openness and compliance with group (in group loans) · Ability to repay previous loans
Capacity	Business's ability to repay the loan	· Cash flow of business, taking into consideration family needs · Repayment capacity · Demonstrated capacity from repayment of other loans · Growth in loan size in relation to business growth
Secondary Factors	**Issues**	**What to Look For**
Capital	Owners investment in the business	· Family money invested in the business · Loan use and needs in relation to the type and conditions of loans
Collateral	Loan guarantees, backup sources of repayment if business cannot repay	· Business assets · Personal guarantees · Group guarantees · Family assets
Conditions	Key economic issues that can impact the business's ability to repay	· Economic conditions for that type of business and region · Risk of price fluctuations and possible downswings · Production risks (break-even points)

In microfinance, the most important factor that MFPs consider when making loan decisions is often the existing relationship with and knowledge of the borrower. The Character of the borrower, namely their honesty and integrity, their reputation in the community (as cross-referenced by leaders in the community), their Capacity (commitment) to make their businesses succeed and their history of past

loan repayment are of utmost importance[3]. A borrower that has a proven track record of responsibility and capacity for successful loan repayment with previous loans can generally get financing from its lender. Access to further loans is the core incentive for full repayment.
Collateral, Capital investment and Conditions are secondary factors. Reliance on collateral to secure lending is generally supplemental to one or both of the first two factors. That is, microfinance lenders virtually never rely on collateralization as their primary consideration in lending decisions. When collateral is taken in microfinance, it is generally limited to movable assets owned by the borrower or social pressure from peers. Analysis of character and capacity to repay or likelihood of a client to repay the loan has proven to be the primary factor in the client selection and loan approval process.

In WBG, the MFPs do assess character and capacity to repay. In terms of information on the credit history of potential borrowers, MFPs look at the past repayment history of their repeat clients, though this is not a significant factor in loan decisions. In terms of new clients, MFPs do not have access to information on credit history. There are plans to study the feasibility of a closed-user group under the credit reference bureau currently being installed at the Palestinian Monetary Authority (PMA). The PMA is focusing on the overall credit reference bureau (CRB) which will be mandatory for regulated financial institutions first. Therefore, the study on the inclusion in the overall CRB of an MFP user group is not likely to happen until the general, compulsory system for banks is established and functioning.

In terms of analysis of capacity to repay, the USAID-funded SMART Program implemented by AED has organized trainings for loan officers of 7 MFPs in Gaza during July and August 2007 on client appraisals, cash flow and financial analysis[4]. However, given the short time since the training was provided, there was no information yet available on how many MFPs have actually institutionalized the cash flow based lending techniques within their credit risk analysis. At the time of the training, most of the MFPs did not provide micro loans based on cash flow analysis (although their loan applications did have some information on income and expenditures, and loan officers are asked to look at them).

It was beyond the scope of this study to perform a detailed examination of how effectively MFPs carried out character assessment and capacity analysis as part of their credit risk management systems[5]. However, at the time of the research, all the MFPs interviewed required physical collateral in addition to character assessment and analysis of cash flow; a trend that is relatively specific to the MENA region, where micro-lending takes on characteristics of 'micro-level commercial banking' to a larger extent that traditional microfinance based on collateral substitution seen in Africa and Asia.

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[3] MEDA. (2006). Training module: Advanced credit risk management.

[4] A total of 32 loan officers from CHF, ASALA, FATEN, UNRWA, GWLF, PARC and ACAD participated in the two trainings.

[5] However, the study team strongly recommends an in depth analysis of credit risk mitigation practices of the MFPs in order to improve their loan performance.

1.2. Literature Review on International Practices with Collateral

Collateral can be defined as an asset that a borrower pledges to a lender until a loan is paid back in full. If the borrower defaults on their loan payment, the lender has the right to seize and sell the collateral at market value to offset the cost of the loan loss[6]. From a lender's perspective, there is a strong rationale behind demanding collateral from a loan applicant as loan contracts are easier to enforce when they are secured by collateralizable assets. It is no surprise that 75% of the loans made in both North America and the developing world are secured by some type of collateral[7]. The traditional forms of collateral used by commercial banks and financial institutions offering large loans include mostly non-movable assets such as land titles, real estate, assurance of salary and personal loan guarantors.

In microfinance, movable physical collateral as well as alternative collateral (e.g. social trust bonds) is the most common, not least because of the loan sizes being much smaller than the value of immovable assets. In developing countries in particular, where land titles are difficult to obtain and much of the land remains unregistered, micro-borrowers are looking for alternative sources of collateral to secure their loans from MFPs. In most developing countries, microfinance customers lack forms of non-movable assets (mortgages, land titles, salary guarantees) but possess collateralizable movable assets (automobiles, machinery, jewelry, livestock, household items, warehouse stock) that is pledged to the MFP as alternative sources of loan security. Reforming the traditional practices of banks and MFPs in regards to collateral would open up a wider market for new clients while still providing a security for MFPs against loan loss.

The global microfinance experience indicates that there are a number of different types of collateral assets that have been used in various contexts with varying degrees of success. Examples of collateral used for microfinance lending include but are not limited to:

- Moveable assets such as equipment, machinery, inventory, jewelry or livestock
- Crops and /or future harvest
- Solidarity groups (peer pressure)
- Deposits with a group or MFP (both compulsory and voluntary savings)
- Loan insurance
- Co-signatory (guarantors)

With smaller loan sizes, MFPs can be more flexible in their collateral requirement, taking either what is important to the person, co-signers or counting on group liability as is customary with many traditional microfinance loans. The guiding principle is to hold something that is of value to the borrower, more so than the actual book value.

Use of movable assets, such as tractors, standing crops and even television sets, have been suggested as alternatives in cases where fixed assets are not available for collateral. Many countries have laws that prevent or severely limit the use of movable property as collateral, and require MFPs to obtain written consent from the borrower as part of the loan agreement. In addition, the

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[6] Balkenhol, B. and H., Schutte: Collateral, Collateral Law and Collateral Substitutes (2nd ed.), International Labour Organization, Working Paper #26, 2001, p. 11.

[7] Savavian, Mehrez, Heywood Fleisig and Jevgenis Steinbuks: Unlocking Dead Capital: How Reforming Collateral Laws Improves Access to Finance. The World Bank: Private Sector Development, http://rru.worldbank.org/publicpolicyjournal, March 2006, p. 1.

lack of registries for movable property can make ownership of these assets difficult to prove, thus limiting their use even in the presence of an enabling environment. In some countries, warehouse receipt lending enables producers to use harvested and stored but not yet sold produce as collateral. This could be relevant in WBG as collateral for loans to farmers who have olive oil processed and stored with cooperatives prior to bulk sale.

The synthesis of papers presented at an USAID conference[8] concluded that of particular importance are the laws and institutions that either facilitate or inhibit secured lending by influencing the ease with which agricultural and other rural assets can be used as collateral. The legal environment for secured lending can be strengthened through collateral widening measures that codify land rights, promote legal reform for institutions, cooperatives and NGOs, and expand borrowing laws to increase the participation of the poor. Improving the systems through which collateral can be provided and collected will open the door to a larger client base, while still protecting the interests of lenders.

1.3. Legal Reform efforts on Collateral

Sayayian et al. argue that the three most important components of collateral reform are:

(1) Removing limits on what can serve as collateral. Micro entrepreneurs (MEs) should have the ability to voluntarily pledge any form of property under a general description of assets;

(2) Clarity on what creditors have priority on collateralized assets. Countries should establish a single electronic registry for pledges of assets so competing creditors can resolve disputes over rival claims to a disputed asset; and

(3) Rapid enforcement of collateral agreements. Creditors have the option to seize and sell collateral property independently in th e case of default but, if they elect to go through a summary proceeding, measures should be in place to guarantee a rapid procedure. Courts should only require a valid collateral agreement between the clients and creditor and a proof of loan default[9].

There are instructive examples of collateral reform at the institutional level from Peru, Bolivia and Kyrgyzstan. The MFP Confianza in Peru moved away from single salary guarantees to accepting multiple cash contributions to secure loan balances. They also allowed clients to pledge unregistered land as collateral for loans under US$2,500 and movable assets such as automobiles and farm machinery for larger loans[10]. In Bolivia, where the national law prevents rural peasants from using their small plots of land as collateral, CLA and Procredito used a flexible approach to collateral that focused more on the value of the pledged assets to the client rather than their recovery value to the MFP. Loans could be collateralized with any form of farm or household assets and non-registered land could be pledged as collateral up to 50% of the value of the loan[11]. In Kyrgyzstan, in an effort to get around the lengthy and expensive legal proceedings for registering collateral, repeat clients of Bai Tushum can simply leave their collateral in the MFP's registry for a three year loan term requiring annual repayments. Bai Tushum loans continue to have 12 month terms but clients only have to reregister their collateral every three years.

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[8] Carter, M. and Waters, E. (2004). Rethinking Rural Finance: a synthesis of Paving the Way Forward for Rural Finance conference. USAID, Washington, DC.

[9] Savavian, "Unlocking Dead Capital," pp.3-4.

[10] Emerging Lessons in Agricultural Microfinance, CGAP and IFAD, August 2006, pp. 17-18.

[11] *Ibid*., pp. 35-36.

Ideas and experiences such as these could be replicated in the context of WBG. In the absence of a national asset registry, for example, some MFPs may be able to maintain a registry of clients' moveable assets by themselves.

2. Overall Country Context

2.1. Political Context

The Palestinian Authority was created in 1994 following the signing of the 1993 Declaration of Principles between the Palestine Liberation Organization (PLO) and Israel. A set of agreements followed, granting the PLO the right to establish an interim government in limited parts of the West Bank and the Gaza Strip. The government known as the Palestinian Authority (PA) enjoys semi-sovereign powers today. Negotiations in July 2000 at Camp David did not lead to a final status agreement and the situation between the PA and Israel has deteriorated rapidly since. In September 2000, Palestinians took to the streets in the so-called *Intifada* (popular uprising) calling for an end to Israeli occupation. The Israeli response resulted in assaults on Palestinian civilians and physical infrastructure, and a cycle of violence ensued[12].Israel has adopted a heavy-handed closure policy and applied a strict system of closures denying Palestinians movement and access to their land and cities in the West Bank and Gaza. They also cut off some 100,000 jobs in Israel sending the West Bank and Gaza Strip into adverse economic conditions. This caused an income crisis where the Palestinian labourers were out of jobs and the PA could not offer immediate alternatives to absorb them in the Palestinian labour force[13].

The most potent sign of the closure policies of Israel is the separation wall, dividing up the West Bank cities and areas and restricting access between them. The planned 721 km[14] long Wall is due to be completed in 2008, effectively setting the boundaries between the two sides unilaterally[15]. According to the current Israeli government-approved route, (both completed and planned), approximately 20% of the barrier runs along the Green Line, the original border between Israel and Palestine sanctioned by the United Nations in 1948. 10.7% of the West Bank lies west of the barrier, known as the Seam Zone (mainly in the Ba'arta Sharqiya, Qalqiliya/Salfit, Jerusalem, and Bethlehem regions[16]. The Wall has severely harmed the Palestinian economy and export production, and has restricted the possibilities of future development. It has severely hindered internal West Bank movement and access. Restrictions on movement have affected the economic baseline of the Palestinians in both the West Bank and Gaza Strip with respect to their productive capacity and sustainability[17].

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[12] "United Nations report: Israeli forces have inflicted a 'reign of terror'" , Jean Shaoul, *World Socialist Web Site*, March 24, 2004; "Israel: Brutal crackdown on anti-occupation activists" , Chris Marsden, *World Socialist Web Site*, January 8, 2004.

[13] "Four Years-Intifada, Closures and Palestinian Economic Crisis, An Assessment." World Bank 2004.

[14] http://www.ochaopt.org/documents/ICJ4_Special_Focus_July2007.pdf.

[15] The wall has a planned route of 721 km. According to the current Israeli government-approved route, (both completed and planned), approximately 20% of the barrier runs along the Green Line, situating 10.7% of West Bank west of the barrier—known as the Seam Zone (mainly in the Ba'arta Sharqiya, Qalqiliya/Salfit, Jerusalem, and Bethlehem regions, see: Preliminary Analysis of the Humanitarian Implications of the April 2006 Barrier Projections," *Office for the Coordination of Humanitarian Affairs* (OCHA), July, 2006; Summary of Data Regarding the Route of the Barrier as interpreted by the Israeli Attorney General for the Israeli Supreme Court, February 23, 2005.

[16] "Preliminary Analysis of the Humanitarian Implications of the April 2006 Barrier Projections," *Office for the Coordination of Humanitarian Affairs* (OCHA), July, 2006; Summary of Data Regarding the Route of the Barrier as interpreted by the Israeli Attorney General for the Israeli Supreme Court, February 23, 2005.

[17] "The Wall of Annexation and Expansion: Its Impact on the Jerusalem Area". The International Peace and Cooperation Center, Jerusalem 2005.

As the political situation was worsening, the US administration proposed the Road Map in 2003 in an effort to re-align the two conflicting sides. The Road Map calls for three phases consisting of (1) cessation of violence; (2) establishment of a transitional Palestinian state with provisional borders; and (3) by 2005 achieve a permanent solution resolving the borders issues, refugees, settlements and the status of Jerusalem. To this date, the Road Map has not been implemented.

The Quartet[18], under the leadership of the United States is working towards bringing about political settlement of the Conflict. The US is currently actively engaging the Palestinians and Israelis following the convening of the parties at an international peace conference in Annapolis in November 2007.

2.2. Economic Conditions

The Israeli economy is about ten times larger than the Palestinian economy. Following Israel's 1967 occupation of the West Bank and Gaza Strip, the Palestinian economy was immediately absorbed into that of Israel[19]. Israel took control over the Palestinian borders, trade, natural resources, construction and various other issues that impacted the Palestinian economy.

The integration of these mismatched economies led to full Palestinian dependence upon Israel, especially in the labour market which consisted primarily of unskilled and semi-skilled jobs. Trade was largely dominated by Israeli manufacturers. Palestinians had no trade relations with third countries[20]. Palestinians benefited financially from the income generated from employment in Israel because this increased their earning power, but the economic relationship remained asymmetrical[21].

The political negotiations in the 1990's produced political agreements and economic ones, namely, the Protocol on Economic Relations of 1994 (known as the Paris Protocol) which defined the economic relations between Israel and the PA during the interim period until a final settlement could be agreed. Although the Paris Protocol established a customs union between the two parties, its application did not promote Palestinians to meaningful control over imports, exports, taxes and cross-border movement of persons[22]. Over time, the gap between the two economies widened and the parties' failure to conclude permanent status agreement only furthered the economic problems in the West Bank and Gaza. The Palestinian economy was not able to transform itself into a productive economy to overcome these gaps because it could not set its own independent trade policies. The Palestinian economy could only show intermittent growth cycles related to periods when Israel eased restrictions on movement and allowed greater access to markets[23]. This occurred in 1999-2000 following the closures imposed by Israel in 1996-1997. The same was true in 2005 when the

[18] The Quartet is comprised of the United States, the United Nations, the European Union, and Russia. It was established in 2002. Its first task was the preparation of the Road Map in 2003.

[19] *Reaching Economic Viability for a Palestinian State,* A Solution Oriented Macro Assessment, May 2007. Al-Mustakbal Foundation for Strategic and Policy Studies.

[20] *Challenges and Reforms in the Palestinian Authority*. Fordham International Law Journal, March 2003, Volume 26, Number 3.

[21] Fadel Naqib, *Economic Relations between Palestinians and Israel during the Occupation Era and the Period of Limited Self-Rule*, 2000, University of Waterloo, Canada.

[22] *Ibid*.

[23] Developing a Palestinian Roadmap for Legislative Reform in the Business Sector, Policy Options and Recommendations, September 2006. Al-Mustakbal Foundation for Strategic and Policy Studies.

economy grew by 8% following the ceasefire among the Palestinians factions after the second *Intifada*[24].

Although the arrangements defined in the Paris Protocol technically remain unchanged, Israel's restrictions on movement widened the divide between Palestinian and Israelis on economic issues[25]. In 2006, Israel began its unilateral disengagement from Gaza and it was the first time in nearly 40 years Palestinians were to have "direct" control over and access to an international border: the Rafah point of entry/exit between Gaza and Egypt. Although the disengagement should have created new opportunities for expanding trade and trade relationships, the political context did not permit easing the restrictions on the movement of goods and persons across the Gaza/Egypt border.

The decline of the Palestinian economy triggered by the start of the second Intifada in 2000 and impacted by recent events has left per capita GDP at $1,129 by the end of 2006, about a third less than it is level of $1,612 in 1999. The possible recovery in 2003 and 2005 was again reversed in 2006 as a consequence of the fiscal crisis along with movement and access restrictions, following the Hamas victory in the PLC elections. Since Israel's disengagement from Gaza in 2005, unemployment in Gaza increased from 30.3% in 2005 to almost 35% in 2006, while unemployment in the West Bank actually fell from 20.3% to 18.6%. The percentage of Gazans who live in extreme poverty has been on the rise from 21.6% in 1998 to nearly 35% in 2006[26]. This rate is a result of actual consumption, which means that without remittances and food aid the poverty rate is closer to 67%.

A further precipitous decline in the economy and standard of living of Palestinians resulted when the Quartet withheld development aid in reaction to the Hamas Government failure to meet to Quartet conditions[27]. International development assistance focused on humanitarian aid. The service delivering capacity of the Palestinian Authority was limited by non-payment of salaries when the transfer of VAT and customs duties that Israel collects from Palestinian exporters and importers in accordance with the Oslo Accords, was frozen by Israel.

The private sector is currently the primary venue for job opportunities for the increasing number of unemployed Palestinians. The Palestinian Authority has attempted to absorb workers to alleviate poverty, resulting in public sector growth by 60% from 1999-2006, but many employees have been hired to gain political support, and the unsustainable expansion of the public sector resulted in a severe fiscal crisis for the PA when VAT income from Israel and donor funding was withheld in 2006-07. In addition, imposed border crossings and checkpoints has further prevented the ability of Palestinian businesses to import and export in an efficient manner and has caused contraction in the import-export sectors of the economy[28].

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[24] *West Bank and Gaza Update: Doing More, March 2007.* The World Bank Group, A Quarterly Publication of the West Bank and Gaza Office.

[25] Israel's policies of closures, curfews, checkpoints, physical barriers and minimizing virtually all Palestinian labor flows into Israel following the deterioration of political relations between the two sides, has forced economic decline, see: *Developing a Palestinian Roadmap for Legislative Reform in the Business Sector, Policy Options and Recommendations,* September 2006. Al-Mustakbal Foundation for Strategic and Policy Studies.

[26] Two Years After London: Restarting Palestinian Economic Recovery-Economic Monitoring Report to the Ad Hoc Liaison Committee, September 2007. The World Bank.

[27] These conditions are: meet commitments to the 'principles' of non-violence; to recognize Israel; and to accept previous agreements and obligations, including the Road Map, see: *West Bank and Gaza Update: Doing More, March 2007.* The World Bank Group, A Quarterly Publication of the West Bank and Gaza Office.

[28] Two Years After London: Restarting Palestinian Economic Recovery-Economic Monitoring Report to the Ad Hoc Liaison Committee, September 2007. The World Bank.

Traditionally, the private sector has played an important role in the development of the Palestinian economy, particularly with respect to employment. By 2000, there were approximately 80,355 private establishments in the West Bank and Gaza, with the majority located in Qalqilya, Hebron, Gaza, and Nablus. Average firm size was less than four persons, with gross average capitalization levels of US$ 10,000[29]. In addition, there were an estimated 80,000 micro enterprises, represented mainly by family business activities largely involved in trading, small scale manufacturing, services and agriculture. The majority of businesses have traditionally been concentrated in services (retail, hotels, restaurants, business services) and industry (food and beverage, metal fabrication, textiles/garments and furniture).

2.3. Social Conditions

As of early 2005, there were roughly 3.6 million people living in the West Bank and Gaza, comprising about 40% of the Palestinian population worldwide. It is one of the most densely populated countries in the Arab world with 547 people per square kilometer. Gaza alone has 3,457 people per square kilometer[30]. The refugee camps in the Gaza Strip, originally set up after the State of Israel was founded in 1948, have the highest population densities in the world – reflecting the fact that whilst the population of the camps has increased, the camp borders have not.

The population growth rate in Palestine is high at 3.5%. This is due to elevated fertility rates (6.1% children per woman v. 2.9% worldwide) as well as declining mortality rates. On average, there are 5.6 and 6.9 births per woman in West Bank and Gaza respectively. By 2015 the population will be over 5 million and assuming there is an influx of perhaps 600,000 returnees, the total population of the West Bank and Gaza could reach nearly 6 million. Stresses on Palestine's resources will be further stretched by a youth boom in the demographic profile. The median age of the population is 16 and hence the demand on key services such as education and health will continue to rise[31].

Palestinian water consumption is half the UN minimum daily standard. The physical infrastructure is grossly insufficient for water, electricity and sewage and the pressure on Palestine's limited allocated land for agriculture, infrastructure, economic activity and housing is increasing.

Israel's control of the Palestinian population registry supports a travel permit system which controls nearly all facets of Palestinian movement outside of an individual's immediate village or municipal area. This enables Israel to issue ID cards and determine the place of residence of every Palestinian in the WBG over the age of 16, thus creating administrative obstacles to restrict Palestinian access to large areas of the West Bank including East Jerusalem, the Jordan Valley, Settlement Areas, and the "seam zone", as well as access to and movement between Areas A, B and C (See Map in Annex 1).

Israeli occupation and control has a direct impact on families in the West Bank and Gaza. The strong family-based networks have traditionally functioned as 'shock absorbers' for social and economic pain and loss. However, the absorptive capacity of these traditional networks are not unlimited and it is increasingly evident that coping strategies, such as reducing expenses and using savings, are being exhausted. Family based support networks, that have underpinned the resilience of

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[29] Palestinian Central Bureau of Statistics, Bernard O'Sullivan (2000) SME Sector Study Prepared for the IFC, UNSCO (2000) Special Report on the Palestinian Economy.

[30] The Arc, A Formal Structure for a Palestinian State. RAND Corporation, 2005.

[31] *Ibid.*

the Palestinian people, are under enormous stress and this will increasingly affect social cohesion and stability. The WBG has become increasingly impoverished. According to the UNDP Human Development Index of 2005, it ranked 102nd out of 177 countries listed on the Index. According to the World Bank, the Palestinian GNI per capita declined from US$1,626 in 2003 to $1,120 in 2006[32].

2.4. The Financial System

The WBG has a relatively well-established and liberal financial system encompassing banks and non-bank institutions. There are 21 banks (9 national; 11 branches of Arab banks from Jordan, Egypt, and the Gulf; and 1 foreign bank)[33] operating in the WBG and supervised by the Palestinian Monetary Authority (PMA). The government is not involved in the direct delivery of banking services, but the practices of the private banking sector in the WBG are prudent and conservative. Palestinian banks generally have loan to deposit ratios in the range of 20 to 30%, though on occasion they may get as high as 40%. The recent average ratio for all banks was approximately 24%. The reduction in the average lending ratios was caused by the prevailing political conditions. While banks do extend credit, they focus primarily on well-established borrowers, i.e., those who are personally known and trusted by the bank or who can provide guarantees by collateral such as real property, securities (stocks), and guarantors.

The PMA is the regulatory and supervisory authority over the banking sector, credit institutions and money changers. The PMA was established in 1997 and has the power to set policies for this sector and licenses their operations under the Palestinian Monetary Authority Law No.2 of 1977 and the Banking Law No. 2 of 2002. The Banking Law requires that banks must be joint-stock public companies in accordance with the laws in effect in the WBG. Foreign banks are exempted from this requirement. Applicants for a license need to demonstrate compliance with the banking law, directives, instructions, and decisions in force in the WBG and must satisfy any condition or request that the PMA deems necessary. The Banking Law establishes fit and proper criteria for directors, general managers, deputy general managers and other senior officials of banks. The law provides that the PMA can send inspectors to examine the books of banks operating in WBG, as well as branches of licensed banks operating abroad. The PMA can impose a range of sanctions including the removal of employees; the suspension of board members, including the entire board; and appointment of a conservator, a special administrative committee, or a monitor to oversee the running of the bank. The PMA can suspend or revoke a banking license.

The non-bank financial sector consists of the securities market, the insurance market, the mortgage finance market and the financial leasing market. This non-bank sector is supervised by the Capital Markets Authority. The CMA was established in 2005. Prior to the advent of the CMA, the Ministry of Finance had notional oversight responsibility for capital market licensees. The Palestine Securities Exchange (PSE) and the CMA are jointly responsible for supervising the activity of listed companies and brokers. The securities law requires that entities engaging in security intermediation or providing financial investment advice or fund administrator services must be licensed by the CMA. The law provides that the CMA shall issue instructions on the

[32] Two Years After London: Restarting Palestinian Economic Recovery-Economic Monitoring Report to the Ad Hoc Liaison Committee, September 2007. The World Bank.
[33] Palestine Monetary Authority: www.pma.ps.

licensing procedures, qualification requirements, the management, and professional and technical qualification for applicants. The law empowers the CMA to request licensees to provide it with any information and reports about their operation as may be required. The CMA also has the power to examine the facilities, accounts, books, and records of licensees. The CMA can suspend or revoke a license.

Islamic banking. Islamic banking services are offered by banks and MFPs in the WBG. While Islamic banking is supervised by the PMA, the licensing and regulations are different from secular commercial bank rules. Annex 3 summarizes Islamic banking practices in WBG.

Specialized credit financial institutions. The PMA licenses credit institutions as stipulated in the PMA Law. To date, the PMA licensed only one such institution, the Palestine Banking Corporation. The PMA is currently working on regulations for microfinance providers and initially these new regulations were classified as 'specialized lending institutions'. Through consultations with the microfinance industry, the regulations are being developed to reflect international good practices for microfinance regulation.

The securities market. The securities sector has become well established over the past 10 years, but has remained a limited source of capital formation for Palestinians. Given the political context, individual savings are small and not typically invested in the volatile stock market. However, in 2007 the regulated Alrafah Microfinance Bank listed in the Palestine Securities Exchange and gained some 19,000 new grouped shareholders. The securities sector/market is regulated by the CMA.

The insurance sector. The insurance sector is regulated by the CMA. It is a small market in the WBG and characterized by a limited range of primarily asset insurance products. While demand is being documented for a much broader range of insurance products, including low-cost health, life and property insurance as well as political risk insurance, the insurance sector is not yet convinced of the cost-effectiveness of such new products in the small market[34]. Especially, political risk insurance was viewed by insurance providers to be prohibitively priced, as the probability of call on such an insurance would be high in WBG[35].

Recently, the Overseas Private Investment Corporation (OPIC) has contracted CHF to manage a loan guarantee facilitate for private financial institutions, which includes non-governmental organizations, microfinance institutions, commercial banks and cooperatives, in support of loans to borrowers located in the PA despite existing risk factors. OPIC's primary purposes are (1) To promote jobs for the unemployed and underemployed and to deliver necessary goods and services through private sector development in Gaza and the West Bank (in particular small and medium business growth); and (2) Support Palestinian small and medium sized enterprises (SMEs) by providing a robust, non-bureaucratic and flexible loan guarantee program that is responsive to the immediate and evolving needs of local Palestinian businesses. In addition, the European Palestinian Credit Guarantee Facility will launch a quick assessment mission in February 2008 to review the possibilities for them to introduce loan guarantees for commercial banks lending to MFPs as well as portfolio guarantees for MFPs.

Mortgage market. The mortgage market is a growing market in the WBG. There is one mortgage finance company operating, Palestine Housing and Finance Corporation (PMHC), whose main

[34] As mentioned by insurance providers interviewed during the field study.

[35] In the Palestinian context, there is documented demand from the business sectors for a political risk insurance, but providers consider the probability for such insurance policies to be called very high and thus perceive the cost of offering such a product to be prohibitive for the insured, the suppliers and their re-insurers.

objective is to provide mortgage refinancing and surety for housing loans to Banks which originate mortgage loans. To this end, the PMHC has established two subsidiaries, which provides mortgage refinancing and the Palestine Mortgage Insurance Fund Corporation which provides insurance on mortgages. PMHC provides these services in order to provide a long term source of mortgage refinancing and thereby overcoming a key impediment to development of the housing sector. PMHC has recently signed an agreement with the EPCGF.

The CMA regulates the PMHC and is currently developing the mortgage finance law. Until the new law comes into force, most mortgage transactions have been informal where the developers sell directly to buyers and finance the sale through contractual arrangements. At the end of payment terms, the title is transferred to the owner.

2.5. Legal Environment

The Palestinian legal regime is an amalgam of laws inherited from many different sources[36]. Since 1994, when the PA was established, more legal layers have been added. The mixture of sources has resulted in many inconsistencies and has not reflected current legal business and commercial needs or practices in the WBG[37].

The task to reform the legal regime to support and enable Palestinian economic activity has presented Palestinian lawmakers with a wide range of obstacles and challenges. Several drafts of business legislation have yet to be finalized and enacted and implementation of regulations is needed to bring laws into full force and effect. There is a package of economic/financial sector legislation pending since the late 1990s that includes draft laws like the Secured Transactions Law; a law that sets legal rules for pledging movable assets, which has yet to be enacted; as well as the current 10th iteration of the Companies Law.

Implementation of laws and enforcement of judgment in the WBG are still rather ineffective thereby hampering effective rule of law. As a result, businesses do not have full confidence in a legal system that enables business activity or ensure that their rights are safeguarded. On business registration and regulation, please refer to the World Bank "Doing Business" report on WBG.

In order for an attractive microfinance environment to exist in Palestine, a legislative, legal and regulatory framework must exist which supports the functioning of a free market economy. Efforts have been continuing to facilitate access to finance in Palestine, but evident hurdles still exist. For a list of business laws that currently relate to and enable microfinance lending, see Annex 4. Obstacles relate to the absence of credit track records for businesses; limited guarantee mechanisms resulting from the absence of a land registration system, and the lack of an effective judiciary system. An efficient and established legal framework would provide for the passage of laws by the legislature, consistent with the principles of a free market.

Having an enabling legal environment to support the growth and development of the microfinance market is important to improve the operating environment for both microfinance providers and their clients. An obvious obstacle to MFPs in WBG is the absence of a legal and institutional

[36] The most important sources are Ottoman law, the law of the British Mandate, Jordanian law, Egyptian administrative orders, and Israeli Military Orders, all of which reflect the influence of the powers that at one time ruled over the West Bank and the Gaza Strip.

[37] Because of the dual legal system, there has been great effort by the PA to harmonize the laws of the West Bank and Gaza Strip to create a consistency in legal education, practice and court procedures.

framework to regulate the sector. Although a first Law of Microfinance was drafted in 2004 with EU-support, it was not submitted to the Palestinian Legislative Council (PLC). A new set of regulations is currently being drafted by the PMA. By the same token, there is a secured transactions law that aims to provide both a legal framework and electronic registry of movable assets, but this law is still pending before the PLC. Because there are no formal legal registries for movable collateral, there have been little incentives for lenders to accept such assets as collateral for loans.

To facilitate a more enabling legal and policy framework for microfinance, a number of steps could be taken, including the easing of registration for micro enterprises; the loosening of regulations governing non-mortgage collateral; the strengthening of the effectiveness of the judicial system; and the reduction of cost, complexity and time of property and asset registration.

3. Microfinance in West Bank and Gaza

3.1. Microfinance Demand and Supply

According to a demand survey conducted by Planet Finance on behalf of the International Finance Corporation and Palestinian Network for Small and Microfinance in 2007, the number of potential clients for microfinance services is estimated at 190,000. The estimated potential market size for micro-lending services amounts to US$ 280 million in the West Bank and Gaza[38].

On the supply side, Palestinian MFPs started their operations in the mid 1990s with support of international donors. As of June 2007, the 9 Palestinian MFPs grouped within the Palestinian Network for Small and Microfinance were serving 25,041 active clients (see list of member MFPs in Annex 3). Table 3 presents the latest available performance data of these 9 MFPs[39].

Table 3: Performance of PNSMF member Microfinance Institutions

Selected Performance Data for PNSMF members as at June 2007			
Item		Item	Total ($)
Active Clients	25,041	Outstanding Portfolio	34,530,809
Cumulative # of Clients Served	144,556	Amount Disbursed (cum.)	252,341,209
Loans Disbursed (cumulative)	21 8,165	Average Loan Size	1 ,1 57
Cumulative # of Women Clients Served	103,121	Portfolio Per Loan Officers	199,600
Branches and Offices	71	Average Outstanding Balance	1 ,379
Total Loan Officers	1 73	Total Female Loan Officers	77 (45%)
Total Employees	350	Total Female Employees	1 67 (48%)
Active Clients per Loan Officer	145	Active clients per Staff	72

Of the nine MFPs in the Network, 3 are programs of international NGO s/organizations; one is a Palestinian non-profit company; and five are Palestinian NGOs. In addition to the Network members, the regulated Alrafah Microfinance Bank and the for-profit public shareholding company Al Ameen offer microfinance services along with some 22 savings and credit cooperatives (12 SCAs under PARC serving more than 6,700 members, and 10 very small women's cooperatives supported by ACAD). Together, these MFPs offer individual and group loans for micro-entrepreneurs and households, agricultural loans, Islamic loans, and consumer and housing loans.

With exception of Alrafah, the MFPs are not regulated or licensed as financial intermediaries by the PMA, and are therefore barred from offering savings products to the public. Leasing, insurance and services linked to remittances and payment transfers are also not currently allowed for the MFP NGOs that are registered with the Ministry of Interior. In order to collect savings from the general public or offer insurance services, MFPs would need to establish partnerships with licensed banks and/or insurance companies. See Annex 3 for a list of the MFPs and the products they offer.

[38] Planet Finance/IFC, 2007. Microfinance Market Survey in the West Bank and Gaza Strip.

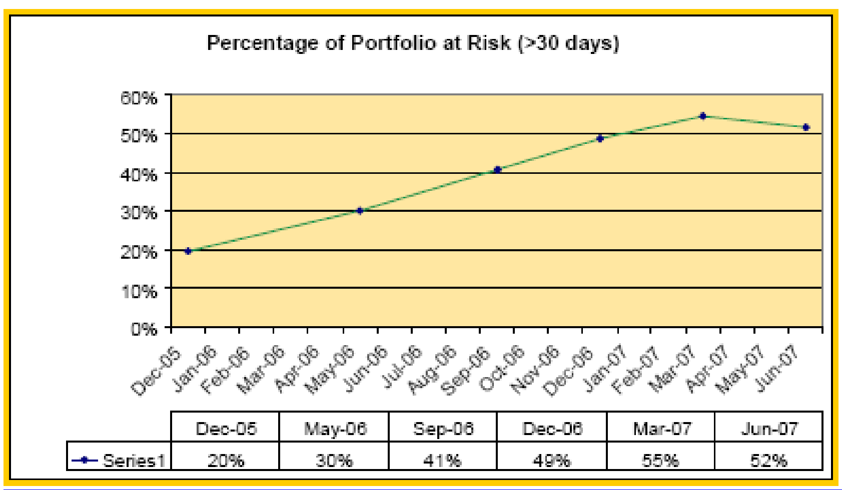
[39] Palestinian Network for Small and Micro Finance, June 2007. Note this table reflects the performance of MFPs which are members of the Network only.

The largest MFPs in Palestine are UNRWA, FATEN and CHF Palestine. They account for 71% of clients and 64% of loan portfolio. In 2006, effective annual interest rates charged by MFPs were between 12% for collateralized loans and 55% for emergency loans. For individual loans, borrowers are required to provide some collateral. Predominantly, this involves submitting post-dated checks or providing personal guarantors with a steady income and the ability to transfer their salaries.

One of the disturbing performance trends during 2006 and early 2007 was a rapid increase in the non-performing loans, putting the financial sustainability of the MFPs at risk. This spike in Portfolio at Risk was caused by the combination of clients affected by non-payments of public salaries; too much reliance on salarized guarantors by the MFPs; and a lack of early warning and mitigation of risk related to years of donor-driven bail-outs. Whereas in 2005 the average portfolio at risk (>30 days) for Palestinian MFPs was at 20%, it peaked to 55% in March 2007. However, a slight decline to 52% was registered as of June 2007[40].

Figure 4 below illustrates this trend using the average portfolio at risk (>30 days) ratio for the nine MFPs which are members of the PNSMF as an indicator.

Figure 4: Portfolio at Risk trend 2005 – 2007.



There is a correlation between this trend and the general economic crisis during 2006, namely the suspension of tax transfers and, consequently, the transfer of salaries for civil servants. Palestinian Authority revenues dropped by 57% from US$ 1.233 billion in 2005 to US$ 530 million in 2006[41], and salaries for a large part of the 164,000 PA employees were not paid. These civil servants' wages directly support another one million people, or more than 25% of the Palestinian population[42] which saw their income reduced by half.

The performance of micro loans was directly affected by this crisis. Overall economic conditions and poverty levels deteriorated. Dependency ratios jumped to 6.2 in the second quarter of 2006 from 4.8 in the third quarter of 2000. People living in poverty rose to 70% in May 2006[43] and real GDP per capita fell by nearly 11% by the end of 2006[44]. Around 70% of Gaza's potential workforce, for

[40] Palestinian Network for Small and Micro Finance, June 2007.
[41] UNOCHA Special Focus, Occupied Palestinian Territories, April 2007.
[42] UNOCHA, Revised Emergency Appeal, May 2006.
[43] IUED poverty figures are used here because the Institute provides the only poverty data on the oPT that allows for comparison with previous years. The poverty line for 2006 is US$2.70 per person per day, with the destitute living on US$1.35 per person per day or less.
[44] International Monetary Fund – World Bank. West Bank and Gaza. Economic Developments in 2006.

example, will either be out of work or go without pay resulting from the 40% unemployment, the loss of PA salaries, and further job cuts through the contraction of the economy and the loss of work in Israel.

The microfinance sector has shown an ability to cope despite periods of crisis and a sharp rise in the non-performing loans (since the majority of the micro loans were backed by salaries of guarantors). But the magnitude of the current crisis – which affects the whole society – has begun to impact the capacity of the institutions to sustain operations and continue to lend. The situation is particularly difficult in the Gaza strip where the effect of the crisis have provoked a dramatic increase in poverty levels with the subsequent shrinking of the market for micro-entrepreneurs. In this situation, many micro-entrepreneurs cannot repay their loans and are often obliged to close their businesses[45].

Given this context, the only way forward for the microfinance industry in WBG is to develop strategies to adapt to the difficult situation both in West Bank and Gaza, e.g. through better credit risk management. The section below discusses credit risk management techniques and reviews a wider range of collateral options. Given the limitations with their current collateral options (e.g. salary transfers, post dated checks and guarantors), MFPs will need to be creative and open to more innovative options for collateral.

3.2. Overview of Current Collateral Practices in WBG

Historically, the entire financial sector in the WBG, including MFPs has based lending on conventional collateral: mortgages, pledges of moveable assets, and guarantors. Because of the scarcity of titled land and the lack of a computerized system for registering pledges of moveable assets, microfinance loans are usually secured by personal guarantees, usually from individuals with salaries that are directly deposited in the bank and often from employees of the Palestinian Authority. The personal guarantee securities has all but collapsed since civil service employees stopped receiving regular salary payments in March 2007, contributing significantly to the high levels of required provisioning (default loans) in some banks.

A CGAP report on the microfinance sector in WBG[46] reported that: "Virtually all lending in the West Bank and Gaza, whether by commercial banks or by MFPs, involves collateralized or at least semi-collateralized loans. Currently, the predominant form of collateral is a guarantee. In the absence of a guarantee, banks generally require direct salary deposit into a bank account which can be offset to pay any amounts due under a loan. This mechanism, however, is obviously not available to micro-businesses and the poor who do not have salaried employment. Both banks and MFPs often require borrowers to deposit post-dated checks (which are then cashed in the absence of a timely loan installment payment), although it is a criminal offense knowingly to issue a check in excess of the amount in one's bank account. Pledges of assets and mortgages (which would be more common for banks than for MFPs) are rare, due, in the case of pledges, to the fact that there is currently no computerized registry for moveable assets and, in case of mortgages, to the fact that less than half of the land in the Gaza Strip and only about 30% of the land in the West Bank is registered. In May 2005, the Cabinet adopted a decree on moveable assets that authorized the establishment of a computerized registry to be housed in the Ministry of National Economy. A law with similar content is expected soon to be adopted. There is also a major effort underway to

[45] Planet Finance/IFC. Microfinance market survey in the West Bank and Gaza Strip, 2007.

[46] Khaled, M., Lauer, K., and Reille, X. (2006). Meeting the demand for microfinance in the West Bank and Gaza.

address the land-titling issue".

This study reaffirms that the MFPs in WBG typically require physical collateral for individual loans, predominantly post-dated checks, promissory notes and/or personal guarantors who are salaried employees, along with land titles and assets when available. None of the unregulated NGO MFPs are allowed to take (or at least to intermediate) voluntary savings, but there does appear to be understanding in the PMA for the need to classify compulsory savings as a loan surety rather than a savings product. Only two MFPs (Al Rafah and UNRWA) are accepting gold as collateral. Annex 3 presents a table that summarizes the current practice of collateral by the MFPs in WBG.

Among the relatively low number of micro enterprises (MEs) with credit needs who actually have applied for credit from institutional sources in the past two years, 37% of applications were rejected, according to a recent market survey[47]. The main reason for rejecting an application was lack of collateral (58%) and lack of guarantor (28%). Among the MEs who have not applied for credit from an institution, 8% stated that the reason was fear for losing their collateral; fear of being unable to repay (33%), fear of rejection of application (10%) and lack of trust in the institution (10%). In terms of preferred collateral, 50% of respondents to the survey indicated that they would be able to provide one personal guarantor; 20% would be able to provide several guarantors, while more conventional collateral such as personal assets (chattel), real estate and salary transfers were less in evidence (14%, 10% and 9% respectively)[48].

As is the case all over the Middle East and Northern African region, the WBG market does appear to favor individual lending over group guaranteed loans, and thus collateral based on social capital (groups, trust bonds) does not immediately appear popular. However, this study found that the reasons for issues with group lending would need to be further examined and proper implementation of group lending methodology would need to be put in place before ruling out the successful provision of group guaranteed loans.

Importantly, 35% of MEs surveyed in the referenced market survey had not sought credit from formal sources as secular lending (with interest) was contrary to their religious beliefs. Thus, there appears to be a large, unmet demand for Murabaha lending (contract sale between MFP and customer) – but the experience among MFPs that offer Murahaba services in WBG indicates that customer who start off on Islamic lending products eventually switch to secular lending, which generally involves less cumbersome procedures. In general, the 'leasing approach' of lending against an asset with the ownership of the asset being transferred to the client only when repayments are completed appears an accepted form of lending in the microfinance market.

Regardless of the continued economic difficulties in the WBG markets, it is evident that MFPs need to increase and expand lending in order to survive and grow. In the shrinking economy, where conventional collateral is scarce, especially among the poor and low-income target population for microfinance, and where the personal guarantees, while preferred by customers, have left providers of credit more vulnerable than before, there is a need to identify alternative and new forms of collateral for individual loans that are:

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[47] Microfinance Market Survey, op.cit.

[48] *Ibid*.

- Available to a relatively large number of (potential) microfinance borrowers;
- Manageable for both borrowers and lenders, i.e. tangible, with a stable value, and commercially exchangeable; and
- Enforceable for lenders, i.e. legally and practically attachable as lien and easy to liquidate in case of default on loans.

3.3. Analysis of Legal and Enforcement Constraints to Collateralized Lending

The study team has reviewed a wide range of possible collateral options identified through literature review, interviews and FGDs with key stakeholders. The following section provides a detailed discussion on each collateral option.

In the WBG, the use of a wider range of collateral is limited by two main factors: (1) incomplete legal framework such as the absence of a secured transactions law or cumbersome execution law which is required to enable wider use of collateral and (2) lax law enforcement. This section provides an analysis of legal and enforcement related issues that hinder the use of wider range of collateral options and substitutions. The analysis starts with the review of collateral documentations used by lenders.

Collateral Documentation used by lenders

Lenders, especially the MFPs, have increasingly relied on the strength of legal documentation, for example, promissory notes, notary deeds, as well as personal guarantees to bridge the gaps caused by both the incomplete legal framework and the lax enforcement. Even those, however, have not provided the comfort level required to inject more capital into the microfinance market because enforcement is still required for them.

The most popular collateral for micro-loans appears to be the notary deed, followed by promissory notes. These are not stand alone guarantees, but legally enforceable debt instruments. The two instruments are used with varying frequency in WBG, with the notary deed more widely used in Gaza than in the West Bank and the reverse being true of the promissory notes. The reasons are simply a matter of tradition and custom.

Promissory Note: Registration of this document occurs when it is issued to benefit the lender. Enforceability is high, since the lender can attach immediately. In addition, the document is self-enforcing and works like a check, provided that the borrower has cash. This document does not have the same legal strength as a check because upon default, the lender cannot bring criminal action against the borrower.

Notary Deed: Notary deeds are debt instruments signed by the debtor before the notary public and registered in the courthouse. Enforceability is high due to self-enforcing mechanisms implemented directly by the Execution Department of the Court.

Review of enforcement issues

From a legal point of view, the reason for the lack of reliance in WBG on alternative (non-traditional) options for collateral that are otherwise the norm for microfinance is primarily due to weak enforcement of such collateral options. Below is a general overview of impediments to collateral and enforcement:

1. Lack of legal regime to register movable collateral. The Palestinian legal system does not have a legal framework for the registration of movable assets. By contrast, immovable assets have a long established registry. The lack of registry for movables coupled with slow and time consuming judicial proceedings, have precluded some lenders from accepting collateral movables. It should be noted, however, that microfinance institutions in many countries have been able effectively to utilize movable collateral for micro-loans by maintaining informal registries and entering clauses and documentation for the ownership of such collateral into loan agreements.

2. Lack of legal basis for priority. Current Palestinian law does not provide a reliable basis for prioritization of various interests in movable collateral. A lender has no way to know whether its collateral interest may be pre-empted by the claim of another lender, the claim of a judgment creditor, a lien of the government or other liens. Loan agreements that are collateralized by equipment are recorded with local courts by the notaries, but the recorded agreements do not give effective notice to other persons, so they are useless as a basis for prioritization even if the law so provided. Collateral interests in shares of stock are usually noted with the stock exchange if the issuer is publicly traded or with the Companies Registry if the issuer is not publicly traded, but there is no legal support for prioritization of claims on the basis of such notices.

3. Difficult enforcement for liquidation of movable collateral. Lenders uniformly report that they have had no success in enforcing a collateral interest in movables upon default of the debtor. The most commonly cited reason is that enforcement processes are so cumbersome and time-consuming that the costs are prohibitive. Other reasons mentioned were that judges are ill-informed on the law and tend to be biased against lenders, especially banks, and in favor of debtors, and consequently will never enforce a liquidation, even when the facts and law are clear. Judges permit execution of judgment to go through every conceivable challenge and defence and permit debtors to drag cases through the process whereby lenders become discouraged to bring future action. Such enforcement problems constitute disincentives to lenders and limit their trust in borrowers whom they do not know. Due process is absent, which shakes the confidence of the public and the private sector in the police force.

4. Limitations on the enforcement against immovable collateral. Microfinance borrowers tend to avoid pledging land to guarantee loans either because they do not own land or because they feel that they are risking a high value property in return for a small loan where there is a disproportionate match between the value of the loan and the value collateral. Also borrowers worry about being dispossessed of their land in the event of default and will not use it for collateral. Absent this concern, if they were to use land for collateral, there are also impediments to foreclosing in the event of default. The borrower has a number of defenses that can be raised at the procedural level which can delay for years seizure and attachment. Public auctions of land tend to be taboo in the Palestinian culture as land is deemed to be part of the person’s identity. At the same time, common ownership of land where division has not been recorded at the Land Authority tends to delay foreclosure procedures, sometime for years. This gives lenders a disincentive to accept land as collateral.

5. Role of lawyers in enforcement is not very effective. Some lawyers do not play an effective role in providing the proper legal advice to their clients, the MFPs. This is often due to the lack of knowledge of the interplay of laws and how to decipher the layers of legislation in force. This

results in giving conflicting advice. Add to this that lawyers' fees are unusually high and tend to overburden MFPs. There are also incidents of lawyers using their personal contacts to influence the judges which may not always be to the benefit of MFPs as this suggests that judges tend to be swayed one way or the other.

6. Judges will only issue judgment in favor of lenders for the principal. Judges refuse to issue judgment inclusive of interest and late-payment fines/penalty imposed by the lender. MFPs are disadvantaged with this unfair judicial practice. Judges are not impartial and disfavor MFPs. They also issue judgment for miniscule monthly payments where the borrower gets to pay small amounts over a protracted period and rarely adheres to the judgment and the lender finds itself back in court going through execution procedures again.

7. Judges rarely issue judgment against guarantors. Because judges tend to be partial in their judgment, they rarely issue judgment against both the borrower and guarantor and thus lenders have little recourse against guarantors.

8. Taking possession of the collateral. Taking possession of the collateral either at the time of extending the loan or upon default requires storage which tends to be expensive for lenders. At the same time, lenders hesitate to take possession of assets because they do not want to deprive the borrower of their use.

9. No bailiff system in the WBG. The court system in the WBG does not have a bailiff system. The police force is weak and thus law enforcement tends to be lax and *ad hoc* due to a wide range of interventions that have left a severely weakened police force. At the same time, the police do not take aggressive steps to enforce judgment against the underprivileged especially women. Sometimes counterforce is used against the police especially in severely poor areas and inside refugee camps where poverty is rampant.

Finally, for banks and other lenders, collateral is a bit problematic because the regulator, the PMA, limits provisioning for debt purposes. The PMA has issued rules to this effect. A summary is provided in Annex 5.

4. Review of Collateral Options

4.1. Immovable fixed assets

Land titles are most often used as collateral for housing loans, but in some cases land is also pledged for business or consumption loans (e.g. education). While land titles are used in WBG as collateral, the value of land most often exceeds the value of a microfinance loan, and therefore would not be the most appropriate collateral to require for micro-loans. Although a micro loan is typically considered to be below $5,000 in WBG, some MFPs do lend larger amounts, e.g. PDF, that takes land titles as collateral for bigger loans (e.g. $20,000). Lack of clear title ownership may prevent its use as collateral. Even where titles are granted and publicly registered, additional factors could limit the use of property as collateral. In countries where there are not clear mortgage laws, or land markets do not function well, then even clear title to land may be insufficient for its use as collateral. Lack of knowledge about establishing ownership and registering collateral may further prevent households and enterprises from using their existing asset as collateral.

Availability: Less than half of the land in the Gaza Strip and only about 30% of the land in the West Bank is registered[49].

In Gaza, 65% of the residents are refugees. They either live in refugee camps where they do not own the land (it was rented by UNRWA for 99 years back in late 40s) or they live in rented apartments/houses. In a demand survey conducted in 2007 (Planet Finance, 2007), only 10% of the respondents in the West Bank and 6.2% in Gaza indicated that they would be able to provide real estate as collateral. FGDs with MFPs conducted for this study confirmed that land titles are not widely available, especially among potential clients for micro loans. As the value of land titles would usually vastly exceed the value of a microloan, it is not recommended as collateral for microloans, but remains an important asset for households and businesses requiring larger loans.

Management: In WBG, registration of land and real estate is carried out by the Land Authority or Treasury Registry. The land registry works fairly well for property that is undisputed and where owners have ensured appropriate registration. However, the vast majority of typical microfinance clients would not have or wish to pledge land as collateral for microloans. If taken as collateral, MFPs must ensure that the registration of the land is valid and up to date. It is wise to ensure that land titles proposed for collateral by a client is fully owned, i.e. not co-owned with others, or – if co-owned – that is has already been subdivided into shares. It may be difficult for MFPs to check and confirm that there are no other liens or claims on the land. Using land titles as collateral requires the MFP to have a safe place for the longer term storage of the land title document.

Enforcement: There are cultural impediments to dispossessing owners from their land even though they have willingly pledged it for a loan in WBG. The process of liquidating a land title for sale through public auction can be extremely lengthy and cumbersome in court. If the pledged land is co-owned by several individuals, as is common for inherited family land, but not yet divided into shares, the process in courts of law can drag on for a long period pending court rulings on division of common ownership in order to auction only the relevant (pledged) shares and not the entire property.

[49] Khaled, M., Lauer, K., and Reille, X. (2006). Meeting the demand for microfinance in the West Bank and Gaza.

4.2. Cash or Near Cash Assets

Cash

Availability: The interviewees of this study indicated that the potential borrowers of micro loans lack cash. If a micro borrower has the cash, she/he does not need to take a loan, as savings in cash would normally be used before a client would seek to obtain a costly microfinance loan. If borrowers have savings, however, cash balances in savings accounts of either the borrower or the borrower's guarantor can be used as collateral. In terms of availability, according to a recent market study on savings, "the current level of deposits in Palestinian banks is over $4 billion. The Palestinian Monetary Authority has indicated that deposits have actually increased in the last two years"[50].

Management: Cash savings of either a borrower or his/her guarantor has been and is being used as collateral. Compulsory savings is often used as part of group lending products, and are equally effective collateral, if rarely covering 100% of the loan amount. In terms of registration, cash can be tied up in favor of the lender by being deposited into a bank account with withdrawal limitations.

The MFPs that participated in this study indicated that they would be willing to explore savings as a possible collateral option, if the new regulations for microfinance providers currently being drafted by the PMA would enable MFPs to collect savings (if not intermediating deposits). NGO MFPs are not currently allowed to mobilize savings, so to use this collateral option, MFPs need to either link with banks to facilitate the savings mobilization for their clients, or become a regulated institution that is legally allowed to directly mobilize savings. In many other countries, it is accepted that even unregulated MFPs mobilize primarily compulsory savings from their clients as partial security for loans (collateral), thereby also instituting sound savings practices among borrowers. A precondition for the majority of microfinance regulators is that MFPs do not on-lend (intermediate) such savings, ensuring that there is no risk to the deposits so collected. The section below on group lending further explores this possibility.

Enforcement: The enforceability of cash is high since liquidation can take place immediately upon default without a court order being required.

Salary of Borrower or of Third Party Guarantor

Availability: Often, microfinance borrowers, i.e. informal micro entrepreneurs or poor households do not have formal, salaried employment. However, low-income wage-earners are common customers of MFPs providing consumer loans, and pledge their salary as surety in case of default on their loans.

Salary transfer of a guarantor has been the most common collateral used both in commercial and micro loans in WBG. However, during the recent economic crisis, the loans backed by salary transfers suffered most. The shrinking number of salaried employees has resulted in near gridlock for lenders using this collateral option. Many MFPs now accept only private sector guarantors that can still document a steady income. As a result, poor people are increasingly excluded from access to

[50] El-Zoghbi, M. (2007). Savings study – West Bank and Gaza. *Draft final report* (not for distribution). UNRWA MMD. According to the author, this is partly explained by an expansion of the commercial banking sector into new regions and branches. It must also represent the capacity of the Palestinian Diaspora to ensure remittances that flow into the economy.

micro loans, as the potential pool of acceptable guarantors is reduced. According to the demand survey by Planet Finance (2007), only 9% of the respondents in the West Bank and 2% in Gaza indicated that they would be able to provide salary transfers as collateral. This confirms the lack of availability in using salary transfers as a collateral mechanism.

Management: Registration of the borrower's or guarantor's salary takes place when the salary is deposited by the employer into a bank account and the lender has been given the proper authority through clauses in the loan agreement to attach the salary as surety in case of default.

Most banks charge a fee from the MFP for agreeing to transfer the salary of a guarantor who has an account with them in the bank, and some banks do not provide this service at all. Consequently, MFPs are able to accept salary surety from guarantors who have accounts only in selected banks which have made an agreement with the MFP to transfer the guarantor's salary in case of loan default.

Enforcement: Enforceability of borrower's own salary as collateral in cases of default is high since no court order is required and the borrower or his/her guarantor is required to pay part of his/her wages to the lender until the loan is no longer in default.

In the case of default by a borrower/guarantor of multiple loans, however, the commercial banks where the salary is deposited take priority when deducting loan repayments in default from the guarantor's salary. Banks are subject to a regulation set by the PMA, to deduct a maximum of 25% from the salary of a given borrower/guarantor in cases of default. As such, MFPs that have taken salary surety from borrowers/guarantors of multiple loans may have difficulties in accessing the total value of the default at the time of default.

Post-dated checks

Availability: After salary guarantors, the second most common form of collateral used for micro-loans in WBG are post-dated checks. This collateral option, however, does exclude many of the poor potential borrowers of micro loans. The minimum balance to open a bank account, and get a check book is high in most banks in WBG, and thus out of reach for the core microfinance market of poor households. The market research conducted in the WBG in 2007 confirmed that 45% of survey respondents did not have a bank account.[51]

Current clients who participated in focus group discussions for this study in West Bank indicated that MFPs, like UNRWA and FATEN, take postdated checks in combination with salary transfers and guarantors. This indicates that post-dated checks by themselves are not seen as sufficient collateral, but that a salary guarantor is required in addition. For the small loan sizes normally provided in microfinance, post-dated checks should seem sufficient on their own, as the deterrent effect of signed checks that could – and would – be cashed in case of default is high. MFPs confirmed that post-dated checks are effective as MMD repayment pressure on borrowers, since a bounced check is a criminal offence which carries a fine or prison sentence.

Management: For the (few) microfinance borrowers that have bank accounts with check books, taking

[51] El-Zoghbi, M. (2007). Savings study – West Bank and Gaza. Draft final report (not for distribution). UNRWA.

post-dated checks as collateral is easy to manage. The MFP is required to have safe storage for the checks and must return the checks to the borrower upon repayment of the loan. In case of default, the MFP presents the check to the bank of the borrower for immediate liquidation.

Enforcement: This collateral option is a self-enforcing procedure implemented directly at the Execution Department of the Court. If a post-dated check is presented by the MFP and bounces, however, enforceability of the ensuing criminal case can be problematic in practice, especially with women borrowers - it is perceived to be a social taboo to require a woman to go to prison.

Remittances

Availability: Remittances are transfers of money sent via remittance service providers such as Western Union, and cash carried by or sent via visiting family members or friends, either from abroad or elsewhere in WBG. The PA seeks to register remittances, but they are by nature difficult to trace. As the PMA has placed restrictions on transfers, informal transfers by carriers have become more widespread. As in most other countries, this form of collateral is not used in Palestine because remittances are rarely regular in nature and cannot be easily traced and attached. Historically, the level of remittances coming into WBG from migrant laborers in Israel has been very high, but the limitations on job opportunities for Palestinians in Israel in the past few years has significantly curtailed this inflow of cash - registered incoming remittances in 2000 totalled $328 million while in 2004, they totalled only $53 million, or an 84% decline[52].

In addition to informal remittances from family and friends outside of WBG, money transfers, including retirement benefits/pension for retired government employees, monthly financial assistance to very poor families from the Ministry of Social Affairs and regular money transfer from the government trust fund to certain deceased people's beneficiaries in Gaza, could be a possible collateral option as such transfers mimic salaries in their documented and regular flow. However, they are limited to a small minority of the population and have become increasingly unstable since 2005, given the fiscal crisis of the PA.

Management: Attaching remittances as collateral for a microfinance loan is a process similar to the attachment of salary of the borrower or his/her guarantor, involving agreements with the remittent (as a type of guarantor) and the remittance receipt point (Western Union outlet, money changer or bank). The lender must ensure that proper authority to attach remittances as surety in case of default is provided through clauses in the loan agreement.

Currently, unregulated MFPs in WBG are not providing remittance services, primarily due to their perception that remittances are irregular and insignificant, but also because NGO MFPs are not legally permitted to offer such services. However, the lack of information on the magnitude and sources of remittances and the potential of remittances should be studied more systematically, as incoming remittances may be much more significant than generally thought. While only some MFPs would have the branch network and capacity to develop and deliver remittance services, such services could be offered by all MFPs in partnerships with banks or remittance providers; in several other countries, Western Union partners with MFPs to ensure services even in remote areas. A new technical guide that is being developed by CGAP on remittances will be a useful resource to study this collateral option further, also by the PMA in the drafting of new regulations for microfinance in

[52] World Bank and Gaza Update: November 2004. The World Bank Group, A Quarterly Publication of the West Bank and Gaza Office.

WBG.

Enforcement: As a surety attached as collateral for a loan through clauses in a loan agreement, the liquidation of incoming remittances via official and registered remittance providers is a self-enforcing mechanism that would not require legal action and hence would be easy to enforce. Informal remittances are much more difficult to track, trace and confirm and thus do not provide a safe collateral option for the lender unless an MFP has a local monopoly on financial services (e.g. in a remote village) and has the legal permission to offer remittance services, i.e. is the only point of receipt for remittances sent in from elsewhere in or outside the country.

Stocks and Bonds

Availability: The typical microfinance borrower does not own stocks or bonds, and this option is therefore only mentioned for the sake of completeness. Bonds are not available in the WBG, and no Palestinian corporate entity has issued bonds. The PA cannot issue bonds because it cannot provide sovereign guarantees. Stocks are available and registered with the Palestine Securities Exchange, and are a valid collateral option for large loans by the wealthier segments of society that may invest in stocks. The Alrafah Microfinance Bank listed on the PSE in 2007, and did sell stocks to customers through a group mechanism. Such sellable ownership stocks could be considered as relative safe collateral for microfinance loans offered by the bank.

Management: Registration for Stocks occurs at the Settlement and Clearing Center at the Palestine Securities Exchange where pledge notices take place. Stocks can be liquidated immediately, and thus for borrowers that own stocks (and listed financial institutions), management of stocks as collateral is not very cumbersome, although the value of stocks at a given time of sale would obviously vary and cannot be guaranteed to cover the entire loan amount in case of default.

Enforcement: Enforceability is simple, as the lender can sell the stocks upon default if the stocks pledged have been appropriately registered in the name of the lender.

4.3. Personal guarantors

Two types of personal guarantors exist: (a) the cash guarantor being a third party who agrees to put down his/her cash balance in his/her bank account as security of a loan repayment (see above 4.2); and (b) the non-cash guarantor being a third party who guarantees a loan repayment through his/her reputation (and potential pressure on the borrower to ensure full repayment).

Availability: In WBG, personal guarantors has been extensively used by all MFPs, both cash and non-cash types. The demand survey conducted in 2007 by Planet Finance found that 50% of the respondents in the West Bank and 26% in Gaza were willing and able to provide a (non-cash) guarantor, and saw this as the most preferred collateral[53].

However, as became evident during the economic crisis in 2006, the personal (cash) guarantor system has all but collapsed since border closures disallowed Palestinians from working in Israel and Israel withheld revenues from the Palestinian Authority, which precluded regular payment of salaries to public sector workers since March 2007. Simply put, too many cash guarantors are

[53] Planet Finance, 2007.

guaranteeing too many loans on too shallow an income, which left all MFPs with very high numbers of defaulted loans which the guarantors proved unable to cover. Non-cash guarantors have been used to a large extent by most MFPs and do work to some degree. In situations of extreme economic hardship, as in Gaza over the past year, however, even guarantors find it difficult to follow through with pressure on families and businesses that have little to spare.

Management: It is well known that the "guarantor market" has been saturated for years with eligible guarantors providing support to multiple borrowers. Rather than looking for alternative collateral, many MFPs increased their (cash) guarantor requirements, asking borrowers to provide a minimum of two or three guarantors, of whom at least one must be employed by specified employers, such as a UN agency or the Ministry of Health and Education, seem to be more regular salary payers.

It has become costly for MFPs to use cash guarantors because the participating banks (where the guarantor has the bank account) often charge a minimum fee of $50. Due to the constrictions in the guarantor market, MFPs also report operational problems such as cash guarantors wanting to get out of an agreement before the loan is fully repaid or a guarantor not wanting to have their salaries fully deducted in case of default. All in all, the cash guarantor option is not a viable way forward in terms of collateral anymore, while the non-cash guarantor system is less effective in times when an entire population is suffering extreme economic hardships, such as presently in Gaza.

Enforcement: Enforcement by the courts against personal guarantors is lax and in some cases almost non-existent. Courts are reluctant to make a guarantor pay because debt is perceived to be personal in nature, i.e. between a creditor and a debtor.

4.4. Moveable Assets, Valuables, and Goods

Gold/Precious Metals and Stones

Availability: Gold is a widespread commodity of high social value in WBG. Every woman traditionally receives a piece of gold (the value of which depends on the wealth status of the groom) at her marriage and as gifts thereafter, and gold is a significant and common gift given in Palestinian families. Therefore, in addition to its commercial value, each piece of gold has a significant social value and personal memories attached to it. The fear of losing it acts as effective pressure on a borrower to avoid late payments or default. The sale or pawning of gold has traditionally also been used as the 'last resort' in economic crises among Palestinian households, thus suggesting that it would have the characteristics of an excellent collateral option. A recent market study on savings found that a third of respondents continued to invest in gold as savings[54], and whereas some potential microfinance borrowers may already have sold out this asset due to economic hardship, key informants and interviewees of this study suggested gold as the most promising collateral option in West Bank and Gaza[55] today. Pilot testing could demonstrate the extent to which gold is still sufficiently widely available to act as an inclusive collateral option[56]. Other than gold, the field study found no mention of other jewelry or precious stones that would be available as eligible collateral. Although precious metals are not generally used as collateral by Palestinian MFPs, several banks, the regulated MFP and UNRWA MMD are accepting this

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[54] El-Zoghbi, M. (2007).

[55] Gold is already used as collateral in neighboring countries, such as Jordan, Lebanon and Yemen.

[56] UNRWA representatives indicated that they began accepting gold six months prior to the study, but had not found many borrowers willing to provide their gold as collateral.

collateral.

Management: Registration of precious metals by the lender takes place on a possessory basis, which requires the MFP to be able to provide safe and secure storage. Based on the experience of Al Rafah microfinance bank, which is currently accepting gold as collateral, it is possible to keep the gold in a safety deposit box at a bank. The cost for the MFP of having gold evaluated and stored is likely to be lower than the cost of management and enforcement of other collateral options currently practiced by the MFPs. Finally, there was some perceived fear among the MFP representatives both in West Bank and in Gaza that poor people will not be willing to give their gold as collateral since it is their security – this observation speaks to the limited experience of MFPs with alternative collateral and only confirms the collateral value of precious metals for borrowers intent on repaying loans in a timely manner, while possibly helping to weed out willful defaulters.

Enforcement: Enforceability of this collateral interest is high because the lender has possession and the value of gold as at the evaluation (time of collateralization) will be unlikely to deteriorate significantly during the period of the loan. Gold trades easily and widely in Palestine, so liquidation would be simple. Given the ease of enforcement and the high social value (likelihood to serve as effective pressure), gold appears a promising collateral option for MFPs in WBG.

Chattel/Household Goods

Availability: Chattel and household goods, such as TV, fridges, freezers, furniture, bicycles, computers, cameras, mobile phones, and the like, are available with all potential microfinance clients, but are not used as collateral in Palestine. The reasons given by MFPs include the absence of an asset registry, the relatively low value and rapid depreciation of such goods, and the costliness of legal enforcement in case of liquidation. Chattel is, however, used effectively in many other countries as surety for repayment of micro-loans on a promissory basis, registered in loan agreements and sometimes confirmed by counter-signature of local leaders or other non-cash guarantors. Some MFPs maintain their own registry of pledged chattel. It would be unusual and perhaps unnecessary for privately owned chattel items to be registered in an official registry, and with the appropriate clauses in the loan agreement, enforcement should be possible.

Management: Chattel is used effectively in many other countries as surety for repayment of micro-loans on a promissory basis, registered in loan agreements and sometimes confirmed by counter-signature of local leaders or other non-cash guarantors. Although each chattel item does not have a high value, collectively the valued sum can be equal to or greater than the amount of a typical micro loan. Because personal belongings often carry a high social value to the borrower, they act as an effective deterrent (pressure) to ensure timely repayment of loans, rather than actually having to be liquidated by the lender. Some MFPs maintain their own registry of pledged chattel. It would be unusual and perhaps unnecessary for privately owned chattel items to be registered in an official registry, and with the appropriate clauses in the loan agreement, enforcement should be possible. Concerns expressed by MFPs during the field study that borrowers in default would dispose of collateralized chattel (and still not repay the loan) should perhaps be subject to practical field testing, as it has not been the experience with this collateral option in other microfinance markets.

Enforcement: Seizing chattel from a microfinance borrower in case of default is never a pleasant experience, and the chief purpose of collateralizing loans is indeed the deterrent effect of ensuring that borrowers will repay loans on time, as the alternative would be unpleasant. During the field of study, Palestinian MFPs expressed concern about the cultural inappropriateness of seizing someone's household goods. This demonstrates the deterrent value of chattel as collateral, while it also speaks to the limited experience with effective credit risk management systems among MFPs in WBG that have accepted sky-high portfolios at risk levels rather than ensuring effective collateral for their loans. The issue of enforcement is addressed in the recommendation section of this report.

Vehicles, Motorcycles, Tractors or other Equipment

Availability: Ownership of cars, motorcycles and to a lesser extent agricultural vehicles and machinery has increased over the past five years in Palestine, and a significant number of potential microfinance borrowers would have a vehicle in the family that could be used for collateral for loans, even if the value of a car would generally exceed the value of a microfinance loan. Registered vehicles are already used by commercial banks as collateral in the WBG.

FGDs with potential borrowers and current borrowers during this field study indicated that agricultural vehicles, equipment and machinery are also available among potential borrowers to be offered as collateral for micro loans.

Management: In order to use a registered vehicle as collateral, a lien is placed at the Motor Vehicle Department at the Ministry of Transportation in favor of the lender. The liquidation by sale of vehicles in cases of default is less cumbersome because the second hand market is vibrant in the WBG, and because there are much fewer legal hurdles and defenses associated with vehicles than e.g. with land. In practice, UNRWA MMD currently accepts vehicles as collateral for loans (e.g. for taxi drivers in Gaza). Upon loan approval, the vehicle is registered jointly in the name of UNRWA MMD and the borrower. Once the loan is paid back, the ownership is transferred back to the borrower.

While agricultural vehicles (tractors etc.) are registered as personal vehicles, collateral interests in machinery and equipment cannot be officially registered because there is no registry for movable assets. However, as with chattel and other goods, microfinance providers in many countries have been able successfully to attach such equipment through documentation of the lien in the loan agreement, as signed by a trusted third party, e.g. the management of a cooperative that the borrower is a member of.

Enforcement: Enforceability of the lien on registered vehicles is simple and the process is relatively swift compared to land. For non-registered equipment and machinery, the lack of a national registry of movable assets has discouraged lenders from accepting this collateral option except in cases where such collateral is offered by large corporations which are solvent, have a proven track record, and can document established revenues from services provided such as telecommunications. For these businesses, the deterrent value of collateralization of equipment has proved to be high for two reasons: (1) the reputation of borrower is at stake; and (2) the lenders take possessory interests in the movable assets and release them back for use by the borrower by contractual arrangement until the loan is repaid. There would seem to be potential for MFPs to use this same approach in loan contracts with microfinance borrowers pledging smaller but equally valuable equipment and machinery as collateral for loans.

Microenterprise Stock, Input and Inventory

Availability: Many of the micro- and small enterprises which are potential core microfinance customers have business assets such as inputs, stock and inventories on shelf, including seeds, fingerlings or chicks; orchard trees; fertilizer/pesticides; other raw materials and shop stock for trade. In international microfinance practice, these assets have increasingly become effective collateral for micro loans, as they are critical to the success of the business being debt-financed by a lender (and are therefore valuable to the borrower). This study found that awareness and consideration of such assets as collateral for microloans was very limited among lenders in WBG. Based on well-established practices from other countries, these business assets would seem an appropriate type of surety for microloans also in WBG.

Management: Collateralizing business asset requires registration but can obviously not be possessory, as the assets are required for operating the business of the borrower. The value of stock and inventory assets can, however, be evaluated and set at the time of signing the loan agreement and the pledging at the confirmed value of the assets by the borrower to the lender is made in clauses in the loan agreement. The borrower will sometimes be required to submit updated lists of stock, input and inventory (new acquisitions and sales) to the lender during the loan period, to ensure that both parties are informed about the value of the collateral. The collateralization of stock and inventory can be a very effective deterrent to borrowers as their business assets would effectively be seized and liquidated in case of default of loan payments. MFPs are well advised to seek legal advice in formulating the pledging clauses in the loan agreement before signing, so that possible enforcement constraints are minimized.

Box 5: Example of warehouse receipt finance[57]

Ware-house Receipts as collateral

The USAID-funded project "Rural SPEED" works to expand rural residents' access to financial products and services in Uganda. Rural SPEED works with a development bank to enable farmers to store their crops in a warehouse between harvest and time of sale. Produce is quality graded and valued at time of storage and a receipt is issued with the estimated sales value of the produce. This receipt is accepted by the development bank as collateral (80% of the estimated value of the produce at current prices), for loans to the farmers. The loans see farmers through to a time when the price of produce has increased and they sell. The bank has access to the warehouse to inspect and verify produce and valuation. This collateral option is helping Ugandan farmers to overcome two challenges — the cyclical nature of farm income and lack of access to credit — that kept many of them operating at or below subsistence level.

Enforcement: Enforcement of this type of collateral in a case of default would entail taking possession of the pledged stock. Taking possession of any property belonging to third parties, when used as collateral, requires judicial proceedings and at minimum an order from the execution department at the courts. This can sometimes be difficult to obtain, but clear and legally well formulated loan agreements pertaining to the pledged collateral can help.

Receivables (Service Contracts, Crops, Produce, Products, Warehouse receipts)

Availability: Agri- and horticulture remains one of the most important income generating activities for many low-income, rural Palestinians. In addition many other micro enterprises have contracts for future sales and products which could be used as collateral. There is thus prevalent availability of receivables as potential collateral among the core customer segment for microfinance loans in WBG.

Microenterprise receivables, such as contracts (both for future sale of service and other products, such as sewn garments, processed food stuffs etc), serve as collateral for micro loans in many countries. There are also successful examples of warehouse receipts being used as collateral (see box 5 above). Especially for farmers, the opportunity to pledge standing or stored crops as collateral for loans enables farmers to benefit from seasonal and supply-demand related price increases of produce rather than having to sell immediately after harvest (see Box 6).

Box 6: Example of Receivables as Collateral

> **Receivables as Collateral – Example from WBG**
>
> According to the Ministry of Agriculture, Palestine (2005) has:
>
> Total cultivated area (crops): 1,833,350 dunums (1,833 km2)
> Area for fruit tree orchards: 1,147,525 dunums (1,147 km2)
> valued at US$ 168.9 million
> Area for vegetables (green houses): 179,139 dunums (179 km2)
> valued at US$ 254.9 million
>
> The USAID-funded PAPA project is working with a local MFP, namely PARC, to provide seasonal loans to smallholder farmers of strawberry and cut flowers. The future produce is used as collateral in a tri-partite agreement between the farmer (borrower), the lender (PARC), and the buyer and exporter of the produce, Sinokrot Group. This agreement requires the borrower to deliver a pre-determined amount of produce to the buyer, and guarantees the farmer a pre-determined price payable by the buyer at the time of sale. The lender (PARC) provides financing to the farmer, and the buyer agrees to deduct the cost of the farmer's loan repayment from the sales revenue of the farmer's produce at sale, if the farmer has not repaid the loan directly. In order to minimize the external risks of market access, the project links to Israeli buyers that can facilitate the timely transit of produce across the border crossing to Israel. The buyer (exporter) absorbs the risk related to market price. See Annex 6 for details on this collateral option.

Management: Collateralizing receivables normally requires a partnership between the lender, the farmer and a third party, typically the buyer of the produce. Registration and valuation of the receivables is documented either in a contract (purchase order or similar) or in a sales agreement with the buyer. If warehouse storage is involved, the management of the ware house (e.g. a cooperative) can act as the third party, who verifies and documents the quantity and quality of stored produce. The collateral interest of the lender in the receivables is registered with the lender, buyer and producer (borrower) in the loan agreement signed by all parties, ensuring that the lender will be repaid either directly by the borrower or from the sales value of the produce managed by the buyer. Collateralization of receivables is also practiced in Islamic financing, in the product "bay'mo'ajjal" (early selling) where the lender buys the future produce (crops, manufactured products or services) and pre-pays before delivered.

Enforcement: In tri-partite agreements where the collateral interest of the lender is recognized by all parties, enforceability is easy and does not require legal action. Enforcement problems can occur if the production or sale fails for reasons beyond the control of the borrower and/or buyer, e.g. as caused by natural disasters, market price collapses or border closures as a risk specific to WBG. This is why debt-financing of production with receivables as collateral is often combined with a price index insurance for the borrower (under-writing the pre-determined price for the produce) and/or a weather-based index insurance (under-writing the pre-determined value of the standing crop if harvest fails due to abnormal weather.

Livestock

Availability: Globally, livestock is a very common collateral for microloans due to its widespread availability and high social value to the borrower. Livestock is also easily prices and traded. Livestock is widely available to the vast majority of potential microfinance borrowers in WBG, and most households, especially in rural areas, own some type of livestock (e.g. sheep, goats, chicken and turkeys and to a lesser extent cattle, fish and bees). In terms of availability, livestock is one of the most obvious and inclusive collateral options available for microloans in WBG. The social value of livestock is high to the owners,

> According to the Ministry of Agriculture, livestock is prevalent in WBG (2005 figures):

Households:	est. 500,000
Sheep	803, 165
Goats	371,198
Cattle	33, 746
Beehives	64, 685

especially among Bedouins who typically have little other collateral to offer, as livestock often represents a key source of 'savings', and livelihood for years to come. Expected offspring and expected revenues from dairy products increase the future value of livestock.

Management: Due to the combination of commercial and social value of livestock to its owner, this asset typically serves as a very effective deterrent against default on loans, as borrower will not wish to lose their livestock. Curiously, livestock is not used as collateral at all neither by banks or MFPs in WBG, and lenders were found to be unfamiliar with considering this asset as collateral. Some lenders expressed concern over the operational impracticality of taking possession of animals, illustrating the misunderstanding that collateral needs to be possessed by the lender during the loan period. When livestock is used as collateral, it is managed like other unregistered, movable productive assets and thus remains in the custody of the borrower for the duration of the loan repayment period, but is registered, valued and pledged by the borrower to the lender as surety in case of default in clauses and annexes (e.g. with photo documentation) to the loan agreement. The loan agreement with the documentation of the pledged livestock can be counter-signed by a trusted third party (non-cash guarantor) to confirm ownership.

Enforcement: In case of default by a borrower having pledged livestock as collateral, the livestock must be possessed and sold in public or private (but publicly advertised) auction by the lender. Often lenders will use an intermediary for the practical recovery, sheltering and sale of animals. When auctioning any asset with a collateral interest, the purpose is to recover the amount of outstanding loan and interest as well as the cost of liquidation (possession, sheltering, sale); any balance remaining after the sale will be returned to the borrower. Legally, MFPs may face the same constraints with enforcing sale of livestock as with other movable, unregistered assets, but it should be recalled that the primary purpose of collateralizing loans is the deterrent pressure for on-time repayment that the usage of highly valued assets constitutes.

Natural resources

Availability: According to international microfinance practice, it is possible to accept as collateral natural resources that are available on land owned by a borrower. Such resources may include timber, water or stone that has commercial and social value. In WBG, the only natural resources that are available with significant value are water and stone (for construction). Water is not recognized legally as a privately owned asset (see Enforcement below). However, stone quarried from privately owned land could be considered an assignable asset, and is certainly widely available in the West Bank. Stone would constitute an asset of less value than the title of the land in which it is found, and would thus be more appropriate as collateral for microloans than the land title itself. A land title would, however, be required to document ownership of resources on the land, and thus the constraints of land titling for the majority of potential microfinance borrowers (see above section 4.1).

Management: As with any asset to be used as collateral, ownership by the borrower would need to be verified and documented, and a valuation of the current and/or future commercial value (at sale) of the asset would need to be determined. In considering natural resources as collateral, MFPs would also be well advised to factor in the cost of possession; quarrying stone for sale is not inexpensive. It may, however, be possible to valuate this asset with a fixed (or minimum) price service contract for a quarry or contractor to access and buy the stone from the lender in case of default by the borrower on a collateralized loan. The field study found MFPs to be reluctant to consider this asset as a collateral option, due to perceived difficulties in determining the future commercial value of the repossessed asset; and due to the costliness and possible protracted timeline for liquidating this type of asset.

Enforcement: Legally, water cannot be used as loan collateral in WBG because water is a common good and belongs to all Palestinians. Water resources are managed on their behalf by the Government as stipulated in Water Law No. 3 of 2002. Under the Water Law, a license is issued for beneficial uses only, and therefore there is no private ownership of water and no registry. Licenses are non-assignable. Stone does not have the same legal limitations, but is a cumbersome collateral to manage and enforce for inexperienced MFPs, and should probably only be explored in partnership with private contractors on construction projects, where a tri-partite agreement as for receivables (see above) could be concluded.

4.5. Collateral Substitution

At its core, microfinance is financial services to poor and low-income people that do not have access to conventional banking services, often because they lack traditional collateral. The success of microfinance worldwide stems largely from the innovative use of non-conventional (alternative) collateral mechanisms to encourage and enforce repayments of small loans. Collateral substitution pivots around the historic global experience that the fundamental repayment motivation for microfinance borrowers is the possibility of accessing another (and larger) loan in future.

The promise of progressive access to (increasing) loan amounts for microfinance clients who repay their current loan on time is thus the most fundamental operating principle in micro-lending. It encourages loyalty by borrowers who can expect to access larger future loans if they perform well in terms of repayment, and it discourages willful default as tantamount of exclusion from credit. This principle is the core reason for the focus on sustainability in microfinance. If MFPs are not sustainable, they cannot assure clients that their institution will be around and able to provide the loan amounts demanded tomorrow. “Stop and go” credit projects whose loan disbursements depend on availability of donor funding do not imbue customers with the confidence that they will have access to credit in future, and hence cannot build up the loyalty and stability of operations required. Sustainable MFPs that are able to attract sufficient commercial capital, and to maintain and grow the value of their capital on the other hand, can ensure customers that they will be there for them in future. While not sufficient, this promise in itself is adequate for microfinance borrowers in many countries to repay current loans, and thus serves as substitution for physical collateral for the vast majority of core microfinance borrowers that do not have access to conventional banking.

To strengthen the repayment motivation without excluding the poor customers that are the target market for microfinance by introducing physical collateral requirements, peer group guarantees evolved as a second and widely successful collateral substitution mechanism for micro loans, especially for women borrowers at the lowest ranks of the economic pyramid.

Utilized for group lending which still remains the largest microfinance loan product worldwide, group guarantees employs social pressure and mutual trust relationships among members of a community to reinforce on-time repayments. Social trust bonds (and therefore group guaranteed lending) are strongest when groups are self-selected (groups are voluntarily formed without external interference); and the social pressure from self-selected peers works best when group members:

- live in physical proximity (neighborhoods);
- have similar requirements for loan amounts and terms;
- have diversified (non-competing) businesses; and
- where group leadership (debt collection responsibility) is uncontested (unanimously elected, rotating).

In some country contexts, the social pressure that makes it socially unacceptable not to meet repayment obligations is reinforced by local authorities (village chiefs, local leaders of mass organizations); in other contexts the social trust bonds and inter-dependency of the group members functions better without external pressure. In all cases, however, the skill and empathy of MFP loan officers monitoring groups has proved to be crucial. The quality of the support, mentoring and unbiased arbitration by loan officers, especially if a group experiences repayment problems from one or more of its members, can make or break group guaranteed lending programs. In particular, loan officers must be trained to detect and deter collusion among group members.

Four MFPs in WBG are currently providing group lending: ASALA, FATEN, UNRWA and Al Rafah Microfinance Bank, but all require additional collateral (e.g. salary transfers) for group members to access a loan. It is not evident why social trust bonds and group pressure is deemed insufficient as deterrents against default, but MFPs do report reluctance to engage in collateral substitution due to unsuccessful performances by some programs in the past (see Box 7).

Box 7: Lessons Learned on Collateral Substitution

Group Guaranteed lending – Example from WBG

Two years ago, the Gaza Women's Loan Fund supported by ANERA and managed by the local NGO, Culture and Free Thought Association (CFTA), offered group lending, but due to high levels of default, they stopped the program in 2006. According to an evaluation conducted by a consultant in 2007 with funding from USAID/SMART program, the main reasons for the failure were:
(a) the members of the groups were not homogeneous;
(2) the group members came from different neighborhoods which reduced the effectiveness of social pressure;
(3) there were only three group members in each group which did not allow high level of social pressure on the borrowers; and
(4) CFTA did not effectively separate their grant-based social services and their GWLF credit program, which confused group members.

As the evaluation illustrated, the failure of this group guaranteed lending program was not necessarily due to the methodology, but rather the product and delivery system were faulty. In addition, there were problems with group selection and staff knowledge of when to intervene in a group before it became dysfunctional with collusion to stop repaying.

In order to realize the full potential of group guarantees as effective collateral substitution, MFPs must internalize, adhere to and fully implement the methodology as adapted to their context, and reasons for failure should be lessons learned for the future.

Availability: Especially among new women borrowers with very small businesses (and hence small loan requirements) in WBG, group guaranteed lending would appear a very appropriate methodology and would replace the current requirements for physical collateral that exclude many of the poorer and less empowered potential microfinance borrowers.

Box 7: Lessons learned on collateral substitution

This study could not identify any characteristics in the WBG market that would preclude successful collateral substitution for micro loans, except perhaps the perception of MFPs that customers cannot be trusted to repay without the threat of dispossession of assets. The mixed experience to date with group guaranteed lending in WBG may be due more to a limited understanding and implementation by MFPs of the practices embedded in this methodology rather than to any inherent 'mistrust'among Palestinian micro-borrowers. Ironically, the decision by the majority of MFPs in WBG to stop lending during the peak of the economic crisis in 2006 in order to limit credit risk may, from the perspective of collateral substitution, have compromised the promise of progressive access to credit by customers.

Management: Collateral substitution is part of a lending methodology that embeds several other, specific practices, and MFP staff and managements must be carefully trained in all the aspects of the methodology in order for implementation to be successful. Thorough client character checks and cash flow analysis should be completed and the MFP needs to have control systems in place to verify that groups are not 'fake' or heading for collusion, i.e. intent on willful default.

In addition to the application of social trust bonds and social pressure, it is not uncommon for MFPs to require groups to save to a group fund. Typically, this internal fund is built through compulsory savings put down by each group members in small amounts over time. While group members are entitled to leverage their savings at a pre-determined ratio to access a loan, the group fund can also serve as surety against late repayments, so that a late/defaulting group member 'owes' the group fund rather than owing the MFP (see Box 8).

Enforcement: Group guarantees are self-enforcing and do not require legal intervention. One of the attractive features of group guaranteed lending to groups with internal saving funds is that it allows unregulated MFPs to encourage savings among their clients whilst not violating prudential regulations that disallow NGOs from accepting deposits. It also encourages group members to build up savings for themselves.

Box 8: Example of Group guaranteed lending

Collateral Substitution

A program in Yemen offers group guaranteed lending, where each member of a group can take a loan up to 5 times her savings but the outstanding balance of the group should not be more than 200% of the savings of the whole group in the first year. Over time, this leverage can be increased to 300% etc. This allows the group member to borrow far more than her savings, guaranteed partially by the savings of group peers who do not have loans outstanding. All group members retain an interest in each member paying back her loan on time so that the benefit of a loan can rotate to the next group member.

4.6. Leasing

Leasing or hire-purchase is an effective alternative to loans as a means of debt-financing because it allows for the lender (lessor) to retain ownership of the leased (and collateralized) asset until the borrower (lessee) has paid the lease price in full. Hire-purchase is often provided by retail vendors of kitchen appliances, furniture and other larger household goods, whereas financial leasing typically requires a license from a regulator – the Capital Markets Authority in the case of WBG. If an MFP has the capacity to adequately procure, store, manage and service equipment, machinery and other business and household goods (typically through partnership with a warehouse or other subcontractor), leasing offers several advantages over cash-loans for providers of asset financing[57]:

- The lessor (lender) is the owner of the asset in a lease until the item has been fully paid; whereas in a loan, the creditor (lender) only has a lien over the asset;
- Transaction costs are typically lower when contracting a lease than when issuing a loan;

[57] Nair, J. and Kloeppinger-Todd, R. (2006). Buffalo, Bakeries and Tractors: Cases in Rural Leasing from Pakistan, Uganda and Mexico. Agriculture and Rural Development Discussion Paper 28. Washington, DC: World Bank.

- Costs of securing adequate collateral and the cost of foreclosure, in cases of default, are avoided in leases. Repossession of a leased asset is usually easier than taking possession of loan collateral. In leases, the lender is the asset owner and therefore retains possession of the asset in case of default of payment; whereas if collateral for a cash-loan needs to be liquidated, the lender needs to take possession of the collateral (from the owner of the asset) in lieu of the loan. While the former often does not require intervention of the civil courts, the latter does.
- In leasing, the level of default and write-off is generally lower than in cash financing.
- Leasing companies are subject to fewer regulations than banks and generally has lower costs associated with regulatory adherence.

A comparative study of the operations and performance of three leasing companies in Pakistan, Mexico and Uganda respectively (Nair and Kloeppinger-Todd, 2006), it was concluded that the leased asset itself is sufficient as collateral for items of lower value (as in the case from Pakistan with an average lease size of US$3,336). For larger leases, however, additional collateral is deemed required to off-set the depreciation of the leased asset (as in the case from Mexico with an average lease size of US$24,850, where the company would sometimes take chattel mortgage on movable assets). The company in Uganda leases assets to small and medium enterprises and accepts chattel mortgage for at least 20% of asset value along with a personal guarantor for surety.

In the WBG, leasing appears to be synonymous with hire-purchase (rental of an item with regular down-payments including a fee and ownership transfer when payments are completed), and regulations govern both. Leasing transactions are typically characterized by the asset being purchased by the lessor to specifications made by the lessee who expresses the intent to gain ownership of the asset when all lease payments are made. The eight financial leasing companies currently registered in the WBG are all located in Ramallah, and lease assets such as vehicles, heavy equipment and real estate. Some of the leasing companies also provide import and distribution services. None of the MFPs in WBG were found to provide financial leasing services at present, although Islamic sales contract products are offered by several banks and MFPs.

Islamic leasing transactions are offered as *ijara,* i.e. rentals. *Ijara* is a medium/long term mode of financing. Legally, it is conceived as a sale of benefit/usufruct *(manfa).* Conceptually, it refers to medium/long-term rental arrangement for the financing of capital equipment and other fixed assets in which the lessor may provide the required assets to be leased for a certain period of time against payment of fixed (e.g. semi-annual) periodical rentals, i.e., semi annually. Among the MFPs, Al Ameen in Gaza offers ijara along with other Islamic financial services. Islamic financial services require a special license from the PMA, which for example Alrafah Microfinance Bank has not obtained. Several commercial banks offer Islamic leasing services, financing land and real estate as well as certain limited type of movable assets, including vehicles, some machinery, construction equipment and electrical household appliances. They do not finance farm inputs or livestock. Banks obtain the services of appraisers to value the asset and appear to set fees based on market demand and the useful life of the assets.

Availability: Leasing (whether secular or Islamic) can fill the gap in the market for micro entrepreneurs that require business assets or households that do not wish to manage large lump sums of cash themselves. In terms of market demand, 35% of respondents in a recent market survey[58] reported that they had not sought credit from formal sources as secular lending (with

[58] IFC, Planetfinance and PNSMF: Microfinance Market Survey, 2007

interest) was contrary to their religious beliefs. Thus, there appears to be a large, unmet demand for Islamic leasing (contract sale, hire-purchase or rentals). However, the experience among MFPs that offer Islamic financial services in WBG indicates that customers who start off on Islamic lending products eventually switch to secular lending, which generally involves less cumbersome procedures and provides the customer with cash in hand. In general, the 'leasing approach' of lending against an asset with the ownership of the asset being transferred to the client only when repayments are completed appears an accepted form of lending in the microfinance segment of the WBG market.

Box 9: Example of Lease-based collateral

Leased Collateral - Example from WBG

In partnership with a buyer and exporter (Sinokrot Group) and an MFP, the USAID-funded PAPA project has experimented with green houses for small holder farmers as lease-based collateral. Participating farmers need to put up 20% of the investment capital but can access financing from the MFP for the balance, pledging their green house as collateral. The farmers received input supply, marketing, certification and packaging services from Sinokrot, who effectively owns the green houses until the farmers have paid their loans to the MFP in full. The buyer (Sinokrot) can deduct any outstanding loan balances from the sales revenue of produce, but can also reclaim and sell the green house in cases of default by farmers. The project also involves a loan guarantee component provided by the USAID-funded SMART program.

This project demonstrates that it is possible to apply lease-like contractual arrangements, without waiting for the Law on Leasing to pass.

Management: Leasing requires the lessor to be able to procure (nationally and/or via import including customs clearance); store; deliver and preferably also service assets either directly or through a partnership with a specialized contractor (garage, importer, warehouse etc.). Because of the logistical implications of managing the assets, MFPs are rarely seen to offer this service directly. There are, however, examples of partnerships between MFPs and vendors, warehouses and export companies where the financial service is provided by the MFP and the logistics left to the specialized partner (see Box 9). In WBG, the Israeli restrictions on access and movement across border crossings pose a particular constraint to leasing of imported goods, especially in Gaza.

The constraints of the operational demands on the lessor are mirrored in the reluctance by MFPs interviewed during the field study to engage in leasing: The common reasons

(1) Lack of awareness and knowledge of the operational requirements of financial leasing;
(2) Perceived absence of regulations providing incentives (e.g. tax breaks) for lease operators;
(3) Perceived high cost of operation and management (also related to lack of capacity of MFPs);
(4) Perception that leasing is only for larger clients and not for micro borrowers; and
(5) Fear that monopoly conditions may exist among suppliers of lease assets in the WBG where movement and access is restricted which would put the MFPs at a disadvantage in selecting, negotiating and offering assets for lease.

Enforcement: Leasing transactions are made through contractual arrangements, and as the asset being collateralized belongs to the lessor for the duration of the repayment/rental period, liquidation for sale is relatively simpler than for loan-financed movable assets. Currently, there is no leasing legislation in force in WBG, but the CMA has drafted a Law on Leasing; issued regulations for the licensing of leasing companies; and developed instructions for leasing. The Ministry of Finance has issued a tax treatment instruction for leasing. A technical assistance team from IFC is currently supporting the early adoption of the Law on Leasing.

5. Recommendations

The findings and analysis of the context and options, management and enforceability of collateral for micro loans in WBG identifies several important areas where action can be taken to increase access to and inclusiveness of microfinance services as well as to improve delivery mechanisms and credit risk management by MFPs through adaptations of collateral options, management and enforcement. The following recommendations are structured to address issues at the retail level for MFPs; the meso level for industry stakeholders including donors, technical service providers and projects; and at the macro level for regulatory authorities. Annex 8 provides a suggested timeline for sequencing the implementation of the recommendations.

5.1. Retail Level: Recommendations for microfinance providers

*1. **Experiment!** Expand the Pool of Assets Accepted as Collateral*

Access to credit in WBG is limited by restrictive collateral requirements. MFPs tend to require conventional, physical collateral, and often more than one type. However, the pool of conventional collateral assets (cash, personal guarantors, and real property with clear title) is limited. Moveable, unregistered assets (such as receivables, machinery, equipment, livestock, etc.) are not presently accepted as collateral, not because there are prohibitive barriers to introducing them, but rather due to lack of exposure, limited technical know-how, constrained institutional delivery mechanisms and a less than adequate legal framework.

There is an excellent window of opportunity now for MFPs to experience and pilot test a wider range of collateral than is currently available in the WBG with the aim of expanding access to finance. International examples abound of collateral substitution and assignment of collateral that is more widely available to the core microfinance segment of the market, e.g. micro-level receivables, chattel, livestock and gold. Existing contractual instruments like possessory interest, "release" back, and informal registration in loan and lease documentation of pledges supported by third party counter-signatories can be used until such times as the legal framework for business transactions and financial services is developed, as listed in the recommendation below. MFPs interviewed during the field work for this Study indicated that they would be willing to test and incorporate new collateral options in their micro loan products. Among the many collateral options identified and analyzed in this Study, the following are recommended as most prevalent, manageable, and enforceable:

- Moveable assets (such as chattel (households goods), equipment, and small machinery/tools);
- Receivables (warehouse receipts, service contracts, etc);
- ME stock/inventory including in particular livestock;
- Gold;
- Collateral substitution, such as group guarantee used in combination with group savings; and
- In-kind financing, such as leasing.

*2. **Innovate!** Introduce New Financial Products and Services*

Due among other things to a heavily donor-driven supply orientation, MFPs in the West Bank and Gaza have not had much opportunity and drive to adapt, redesign and innovate their product ranges based on market demand. Now is an excellent time to reverse that trend and develop, test and deliver more responsive products that meet the demands of the large potential market of microfinance customers. This would also establish a clearer boundary between conventional banking and microfinance providers that serve the poorer segment of the population not just with 'micro-level banking services' but with specialized, adapted, and demanded products.

Leasing is an example of a financial product that may be appropriate to many microfinance clients. The Ministry of Finance issued the Tax Leasing Regulations of 2006, but very few businesses have taken advantage of these regulations to date. The CMA has recently issued instructions for regulated leasing companies. Rather than developing the entire logistical infrastructure for asset management, MFPs could approach existing leasing companies to forge business alliances to introduce micro-leasing into the WBG market. Some MFPs may prefer to start with (or up-scale existing) Islamic leasing (rental) products, which may be more familiar to the potential market and the providers in WBG.

Another example of innovative financing is Purchase Order Finance (POF). POF is a lending product that enables micro enterprises (or other companies) to fill purchase orders or sales contracts. When an enterprise gets an order for its products, the lender advances sufficient working capital for the company to buy materials, package and ship the order. When the customer pays for the order, the financial institution is repaid the amount advanced, plus interest and/or fees. The borrower's receivable (purchase order or contract) serves as collateral for the loan, and the MFP will be able to deduct any defaults from the customer's payment, thus replacing requirements for borrowers to pledge real estate or other fixed assets they often do not own or have already pledged to other creditors.

Box 10: Example of Innovation[61]

Example of Purchase Order Finance

In Bolivia, the coffee producers association Cooperativa Agropecuaria Integral Nor Este Ltda. (COAINE LTDA) located in Yungas, was the first client to receive a formal Purchase Order Finance (POF) loan. The loan was extended by FIE FFP – a leading Bolivian microfinance institution which has developed new products and opened five branches in Yungas and Chapare with support from the USAID-funded ARCO project. In just five months of operations in these regions, FIE has developed a loan portfolio of $2.6 million and savings of $1.1 million for over 2,000 clients.

3. *Try GGL again! Improve the Implementation of Group Lending Methodology*

The does not seem to be any inherent market characteristics to impede group guaranteed lending with internal savings as collateral. The chief reasons why group lending in WBG has failed in the past appear to have been problems in product design, adherence to methodology, delivery systems (selection and formation of groups), and staff training (knowledge of when and how to intervene to support or deter dysfunctional groups from collusion). Especially for MFPs targeting the very poor and women, group guaranteed lending is recommended as an effective collateral substitution, provided that investments are made to contract expert technical assistance to ensure that the methodology, its delivery systems and credit risk control mechanisms are appropriately understood, adapted to WBG, and implemented.

4. *Use Existing Instruments! Increase the Use of Notary Deeds*

While all MFPs in the WBG are using notary deeds as collateral to some extent, especially in Gaza, it is one of the most effective and manageable instruments available in this industry, and its use should thus be expanded especially in the West Bank to perhaps replace at least some of the reliance by MFPs on the relatively weaker guarantor collateral. The cost (stamp and duty fees) is not excessive and is similar for both territories.

5.2. Meso Level: Recommendations for Industry Stakeholders

*1. **Improve!** Build the Capacity of MFPs in Credit Risk Management*

Interviews and focus group discussions conducted during this study indicated that the performance of the micro loan portfolios of MFPs in WBG can be significantly enhanced through better credit risk management, beyond a reliance simply on collateral. International good practices in microfinance confirm the importance of comprehensive credit risk management, especially credit risk analysis focusing on character assessment (willingness to repay) and cash flow analysis (capacity to repay). One training course on risk management has been held in 2007 in the West Bank, funded by the USAID SMART program which has also funded credit risk management (character assessment and cash flow analysis) trainings for loan officers in Gaza, but this study could not detect evidence that MFPs are actually putting these new skills into practice when evaluating credit risk. Providing one-off training is usually not effective in ensuring continued and proper implementation of new techniques and methodologies.

This study strongly recommends building the capacity of MFPs in comprehensive credit risk management techniques and providing follow up mentoring to ensure proper institutionalization of good practices in maximizing performance of micro loans without heavy reliance on collateral. This would include a greater emphasis and importance placed on character and capacity assessment. Therefore, it is highly recommended that the capacity building program includes follow-up in-house mentoring for each MFP. The PNSMF may be able to offer this service as part of their training program going forward.

*2. **Mitigate External Risks!** Introduce a Political Risk Insurance Scheme*

The study found that a significant part of non-performing MFP loans appeared to be caused by political risks, such as the effects of border closures, demolitions, imprisonment and violence during incursions. Annex 9 presents the number and value of loans that were lost due to political risks as compiled by the PNSMF as at June 2007. Given the fact that these shocks to borrowers are external risks beyond the control of the MFPs, and specific to WBG, it is highly recommended that an insurance facility be instituted for MFPs against political risks. The design and development stages of such a facility may initially be supported by donors, but should involve private sector players to ensure the long term sustainability of the facility.

It is noted that at the time of this study, there were plans by USAID SMART program to contract technical assistance for an in-depth feasibility study for various micro insurance products, including also the political risk for microfinance borrowers growing produce for export based on an indexation of time that perishable goods were held back at closed border crossings. This would be helpful to mitigate external risks and shocks to microfinance customers in general, and to farmers and small holders in particular.

Likewise, the study team noted that discussions are ongoing among donor funded programs (SMART, EPCGF and OPIC) on the possibilities of designing guarantee or insurance schemes to underwrite MFPs accessing commercial capital from banks as well as to underwrite losses in MFP portfolios from external risks.

*3. **Enhance Judicial Enforcement!** Educate Judges*

Educating judges on the importance of balancing the interests of all parties to contractual agreement for micro loans with equal measure will improve contracts enforcement. No matter how poor, micro borrowers who fail to honour their debts are harming the interest of other microfinance customers and are reducing the overall pool of available funds. Therefore, there is a need to eliminate discretionary and selective practices by judges. This requires special training for judges on standing by the text of the contract as opposed to weighing the interests of the parties - in favor of the borrower. At present, most lenders avoid resolving disputes in the legal system at all costs because they feel that the legal system is prejudiced against their interests.

*4. **Streamline Legal Representation!** Establish Legal Unit & Clinics for MFPs and Clients*

It would be helpful for the microfinance industry if a cadre of lawyers would be trained to understand the procedural issues related to enforcement and who would work to advance the interests of microfinance. It is recommended that the Palestinian Network for Small and Microfinance considers creating a legal unit (slimly) staffed with 1-2 in-house legal advisors to review, prepare files and documentation, and follow up court cases. This unit could take the shape of the legal units created by humanitarian NGOs for other rights of law issues, The unit could follow up with lawyers retained by individual MFPs, could perform litigation services, and could manage and coordinate similar cases and files from multiple MFPs. Special fee structures should be negotiated with lawyers to reduce the financial burden on MFPs.

In addition, the legal unit could manage a ‘clinic’ to review cases of customer default from the outset. MFPs would be able to refer cases to this clinic at the first event of default. The clinic would work directly with borrowers, suggesting ways for the borrower to settle the debt and arbitrate between lender and borrower to find solutions rather than entrenching adversarial positions. In the absence of bailiffs in WBG, this could include soft follow up and personal visits to borrowers and guarantors as opposed to a stream of legal notices sent by the MFP's legal department or external legal counsel. Conversely, the clinic would be available for microfinance customers to present and get advice on complaints against MFPs. In this way, the clinic could become a precursor for recourse and consumer education within the microfinance industry. The clinic may be staffed by volunteer lawyers, paid full time legal staff and/or trainees, i.e. young lawyers/students of law wishing to gain practical experience in this emerging field.

*5. **Enhance Police Enforcement!** Work to establish a dedicated police unit*

In addition, there is a need to work with the concerned authorities to consider establishing a special police unit for contracts enforcement. The Palestinian police force would work with the law enforcement authorities and the judiciary to establish such a special unit attached to the Execution Department. The initial work of this unit would be to serve notices of attachment and seizure and to be available to accompany lawyers and MFP personnel when seizing assets from customers in cases of default.

*6. **Promote asset registration!** Advocate for Adoption of the Secured Transactions Law*

With support from donor agencies, the MFP Network should work with the Banker’s Association to advocate the adoption and implementation of the Secured Transaction Law. This law has been in draft for years and is currently pending before the Ministry of National Economy where the registry of movable assets was also expected to be housed. The draft at present requires a final review because it was prepared back in 2004. At the same time, the Execution Law of 2006 has been promulgated and is currently in force. These two laws must be consistent in order to proceed with enforcement issues, core to the issue of collateral. The MFP and Banking Association would work hand in hand (the law is equally relevant to the banking industry) to advocate its enactment and the establishment of the registry.

7. **Enhance Credit Information!** *Establish an MFP window in the PMA Credit Bureau*

The PMA monitors check clearing and notifies banks if a check does not clear. However, there has not been a credit reference service for the financial and business sectors in WBG, and thus lenders have had no mechanisms to check the credit history or determine the extent to which a potential customer has already fully pledged his/her assets to help them determine credit risk . The PMA is currently testing a mandatory credit reference bureau for regulated financial institutions (banks), and it is expected to come on-line during early 2008. The ability to enquire to a database about the credit history of a potential borrower is very useful also to MFPs, especially for customers in areas where multiple borrowing is widespread. However, as MFPs will not be regulated as banks and do not enjoy the same levels of permitted product range and confidentiality protection, mandatory reporting by MFPs to a data base accessible also by banks can lead to customer theft. Therefore, it is recommended that the feasibility is studied of creating a closed-user group within the PMA credit bureau, to which MFPs that report can also enquire about the MFP credit history of potential customers. At a later date, the two databases may be merged. Time wise, it would be unlikely for this to happen until after the general, compulsory system for banks is functional.

5.3. Macro Level: Recommendations for Regulatory Authorities

1. **Promote the Use of Movables Assets as Collateral!** *Establish an Official Registry*

To enable the enforcement of a wider range of collateral options, it is critical for a draft Secured Transactions Law to be adopted and enacted in the near future. This law provides the legal foundation for the establishment of a registry of movable assets where a security interest is registered by the lender thus allowing enhanced enforcement. Further, registration establishes the priority of the secured party’s interest in the pledged assets thereby protecting that interest against other claims on the assets and reducing overall systemic credit risk. An asset registry should be established as an on-line computerized database allowing for data entry and enquiry from both Gaza and the West Bank. The usefulness of such a registry would be greatly enhanced if the two separate company registers in Gaza and the West Bank were also computerized and unified and linked to the asset registry. Similarly, the database should allow for registry conjunction (inter-linkage) with the existing registers of personal status, vehicles and construction equipment.

The study team notes that USAID supported a project to develop the draft secured transactions law and establish the registry a couple of years ago, and thus the initial work on developing this registry has already been done. It is recommended that USAID considers reactivating funding for this important task in the near future.

2. **Support the broadening of collateral options!** *Reform the legal framework*

It would greatly facilitate the enforcement of business and financial transaction contracts, if the legal framework and legal standards for allowing and facilitating attachments to all types of collateral interests in a broader range of business assets would be developed, clarified, and published.

One immediate and very helpful facilitation for lenders would be the confirmation of allowability by lenders to use possessory interests in movable assets and "limited assignment" options. The existing commercial code allows for the formulation of contracts whereby a possessory interest is created between lender and borrower in a movable asset. However, because the borrowers need use of the asset, the lender, through another contract, "releases back" the asset to the borrower for their continued use. In the event of default, enforcement is readily available because the lender has the "possession" and is granted an assignment. In cases where liquidation of collateral is necessitated by a borrower's default, the borrower has limited defenses. The lender also has the right to regularly inspect the collateral at the site of the borrower to ensure that its interest is safeguarded.

3. Enable the enforcement of contracts!

3.1 Establish Self Help Principles

In order to enable MFPs to use self help principles, there needs to be provisions in the loan agreement permitting the lender to seize assets without a court order in the event of default. This goes hand in hand with recommendation number (4) below which is the waiver of legal defences.

3.2 Waive Legal Defences

Related to the above recommendation, it is critical to include provisions in the loan agreement waiving defences for cases when default occurs. With a waiver, the lender would be able to proceed directly to the Execution Department knowing that the borrower would not be able to bring irrelevant defences to delay the process. This could cut the current court delays down from years to months.

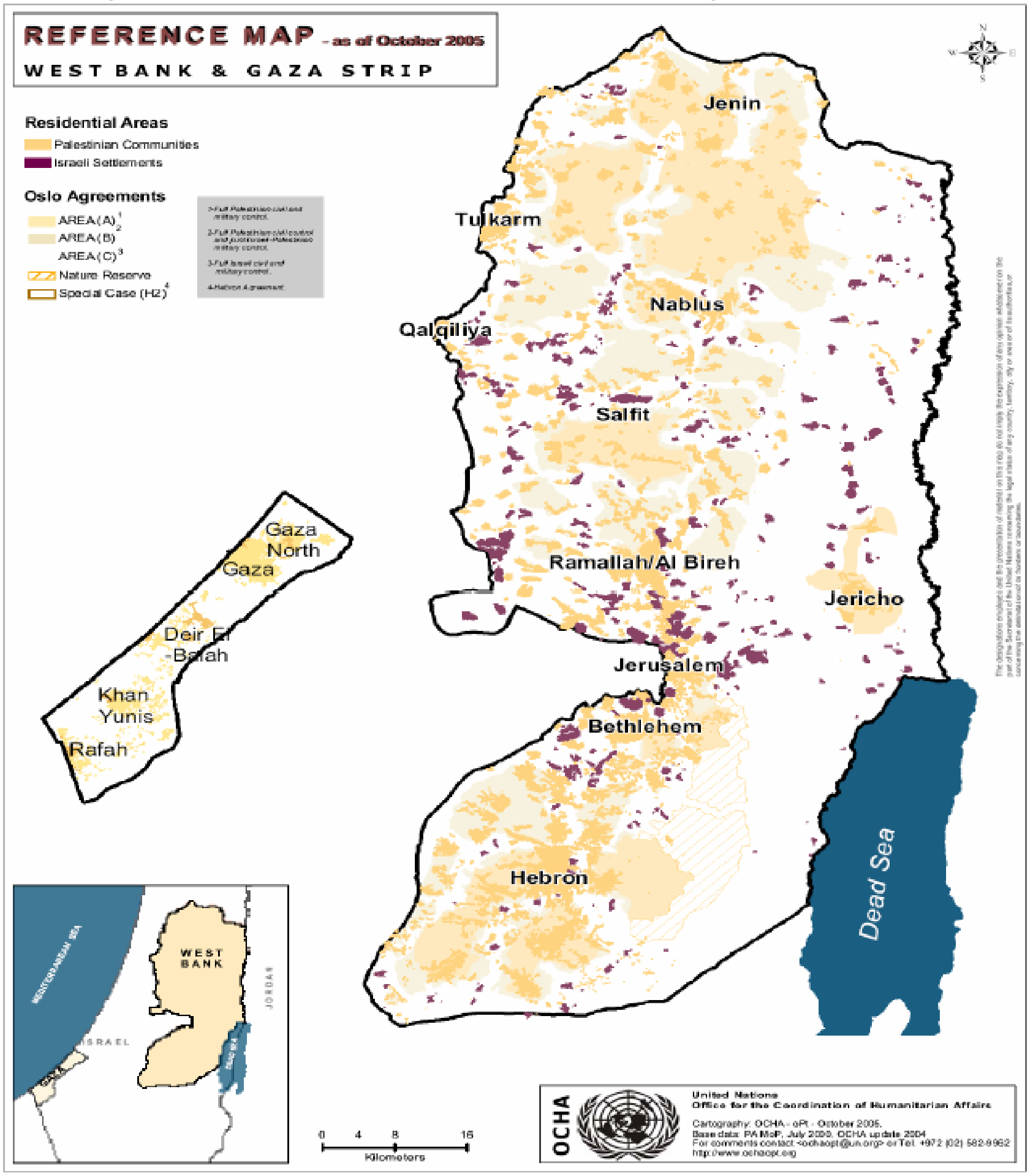
4. Facilitate MFP registration! *Include Non-profit Companies in the Companies Law*

Under the 1929 Companies Law prevailing to date in the Gaza Strip, a non-profit company may be established. The same legal form is not available under the 1964 Companies Law prevailing in the West Bank. At present, the Ministry of National Economy is considering a draft Companies Law that harmonizes both legal jurisdictions. The current iteration of this draft law has eliminated the non-profit company option.

As businesses with a social mission (the "double bottom line"), MFPs often benefit from being registered as non-profit companies while they grow and develop to larger, stronger institutions. Furthermore, elimination of this form would harm existing acquired rights of MFPs who are registered under this legal form. It is therefore strongly recommended to the Ministry of National Economy that the legal form of non-profit company with included in the Companies Law.

Annex 1

Map of West Bank (Areas A, B, C) and Gaza Strip Closures (2005)



Annex 2

List of Organizations Met and People Interviewed

Gaza – Focus Group Discussion (FGD) with MFPs:
UNRWA: Ahmad Husein, Senior Branch manager
FATEN: Samah Safadi, Admin Finance Officer
CHF: Atef Odah, Chief Engineer
GWLF: Mai Masri, Acting Program Manager
ANERA: Salah Sakka, Gaza Manager
Consultant: Imad Abu Dayyah

Jerusalem - FGD with MFPs:
UNRWA MMD: Jane Giacaman, Chief, Microfinance Operations
FATEN: Anwar Jayyusi, Managing Director
ANERA: Mazen Dabbagh, Project Manager, Credit Program Coordinator

Ramallah – FGD with MFPs:
CHF: Alaa Sisalem, Managing Director and Izz Tawil, Operations Manager
ACAD: Ashraf Zein, Operational Credit Manager
ASALA: Reem Abboushi, Executive Director
REEF: Mohammad Abu Dalo
PARC: Randa Abed Rabbo
PDF: Mohammad Al Masri

Microfinance Customers
West Bank – 12
Gaza - 16

Potential (not current) Microfinance Customers:
West Bank – 6
Gaza - 8

Individual interviews: *Microfinance stakeholders:*

– Palestinian Network for Small and Microfinance: Reem Abboushi and Afnan Mahmoud, Network Manager
– Al Rafah Microfinance Bank: Sami Saidi, General Manager
– Palestine Banking Corporation: Amin Haddad, General Manager

Government/Regulatory Authorities:

– Palestine Monetary Authority (PMA): Ahmad Haj Hassan, Acting Division Chief, Macro prudential analysis, Banking Supervision Department.

– Palestinian Economic Council for Development and Reconstruction (PECDAR): Mohammad Shtayyeh, President
– Capital Market Authority (CMA): Atef Alawneh, General Manager

Private sector:

Sinokrot Global Group: Mazen Sinokrot, General Manager, Chairman of the Board of Directors

National Insurance Company: Aziz Abdel Jawwad, General Manager and Hussein Al Seifi, Public Relations and Marketing

Palestinian Banking Association: Nabil Abu Diab, Director

Talal Abu-Ghazaleh & Co. International: Jamal Milhem, Executive Manager

Al-Quds Bank for Development and Investment: George Aboukhalil, Assistant General Manager

Arab Bank: Loay S. Hawash, Credit and Collection Manager-Retail Banking and Ayman Dahadha, Direct Sales Manager, Retail Banking-Palestine

Cairo Amman Bank: Sami Kreitam, General Regional Assistant for Individual Services and Feras Najjab, General Regional Assistant

International organizations:

USAID/West Bank and Gaza: Fadi Abdellatif, Project Management Specialist

USAID/SMART: Lene Hansen, Chief of Party

USAID/PED: Said Abu Hijleh, Chief of Party

USAID/PAPA: Said Sabri, Project Manager

USAID/ West Bank Food Security Program/ACDI/VOCA: Robert Rosengren, Chief of Party

IFC: Khaled Walid Qutob, Program Officer, Middle East and North Africa Financial Market

European Palestinian Credit Guarantee Fund: John Khoury, Director and Hanna Sahhar, Manager

Danida/Middle East-Regional Agricultural Programme: Michael Oellgaard, Reg. Program Manager

Planet Finance: Jacques de Champchesnel, Program Coordinator and Daniel Sorrosal, Executive Director

Individuals:

Banyan Global: Mayada El-Zoghbi, Managing Partner

Microserve, Microfinance Consulting Services: Mohammad Khaled, Managing Partner.

Annex 3

Microfinance Actors, Products and Collateral Practices in WBG

1. Microfinance Actors

The members of the Palestinian Network for Small and Micro Finance are:

The Palestinian Businesswomen Association "ASALA": A local NGO that started in 1997 and targets women with small and micro finance services.

The Arab Center for Agricultural Development "ACAD": A local NGO established in 1993 as the successor of the United Agricultural Company founded in 1988. ACAD targets low income farmers and women in rural areas by providing them with credit and training.

Palestine for Credit and Development "FATEN": A non-profit Palestinian company established in 1998 as the successor the Group Guaranteed Lending and Savings Program launched by Save the Children in 1995. FATEN aims to provide financial services to small entrepreneurs, particularly women.

Palestinian Development Fund "PDF": A non-profit company, initially established as a development institution in 1996 with the merger of three credit institutions financed by the European Union. It provides lending services to the private and informal sector, including small enterprises.

Young Men Christian Association/YMCA, Small Projects department: The Small Projects department was established within the framework of creating various types of jobs that meet the urgent needs of Palestinian Youth. This is done through systematic management training and vocational training, developing and increasing the level of Palestinian youth's skills and knowledge.

Cooperative Housing Foundation "CHF": The lending program Access to Credit (ACP) of CHF, an international NGO, is considered one of the first specialized programs in housing loans in the West Bank and Gaza Strip. The program was established in Gaza in 1995 with USAID grant, and expanded its lending program to West Bank in 2001.

American Near East Refugee Aid "ANERA": Since 1995 ANERA has provided small loans to farmers and women, the latter through a local NGO in Gaza, funded by IFAD and in cooperation with partnership banks.

Palestinian Agricultural Relief Committees "PARC": Savings and Credit Cooperatives: PARC is registered as a NGO, provides marketing and business services in agriculture and supports savings and credit cooperatives (SCCs). The SCCs are defined as "legally licensed women cooperative groups with independent judicial, financial and administrative status". The membership is exclusively limited to women and these cooperatives are funded and managed by their members. The SCCs undertake savings and credit activities in addition to the other development activities aiming to develop Palestinian rural women and enhance their role in economic, social, cultural and political life. To coordinate business support to the cooperatives, PARC has established a Union of Savings and Credit Cooperatives.

PARC has recently registered a new microfinance provider, Rural Economic Empowerment Foundation "REEF", as a non-profit company in June 2007 (October as the expected starting date of operation). Its mission is to provide direct and indirect financial services to customers in rural areas and urban areas. REEF is majority owned by PARC and will take over some of the financial services provided by PARC to date.

United Nations Relief and Works Agency, Microfinance and Microenterprise Department:
UNRWA' MMD started in 1992, targets small business owners, microentrepreneurs and poor household through credit and other financial services that sustain jobs, decrease unemployment, reduce poverty, economically empower women and youth, and provide income-generating and asset building opportunities.

<u>MFPs outside of the PNSMF include:</u>

Alrafah Microfinance Bank was established in May 2006 with IFC support for the business planning process for 2006-2010. The bank is regulated under the Banking Law by the Palestine Monetary Authority (PMA). It listed on the Palestine Securities Exchange in 2007. Al Rafah's five year business plan projects rapid growth with the aim to reach 10,000 customers and a microfinance loan portfolio of US$ 42 million by the end of 2010.

Al Ameen has been operating since 2002 in Gaza and is registered as a public shareholding company. Al Ameen provides exclusively Islamic financial services, both contract sales and investments (savings).

Several commercial banks, including Bank of Palestine, and Arab Bank have concluded partnership agreements with NGO MFPs to ensure customers' loan disbursements and repayments. Cairo-Amman Bank has expressed interest in down-scaling.

2. Microfinance Products

Products	ACAD	ASALA	CHF	FATEN	AN ERA	UNRWA	YMCA	PARC/ REEF	PDF	Al Rafah MF bank
Credit										
SME	x	x	x	x	x	x	x		x	x
Micro-enterprise	x	x		x		x	x	x		x
Group lending		x		x		x		x		x
Housing			x	x		x	x			x
Consumer/personal						x				x

Agricultural	x									
Islamic finance	x			x						
Savings										x
Remittance										
Insurance										
Leasing										

3. Current Collateral Practices by MFPs in WBG[59]

	Guarantors and salary transfer	Post dated checks	Group pressure/ group savings	Voluntary savings	Gold	Notes
ACAD	x	x				
ASALA	x	x	x			The guarantors must be private sector or NGO employees, PNA employees, or merchants.
FATEN	x	x	x		x	Salary transfers for larger loans (e.g. housing).
PDF	x	x				Take household goods (e.g. furniture). For larger loans, takes land title.
PARC/ REEF	x		x	x		In addition to savings, they require guarantors
AN ERA	x					Stopped taking post-dated checks
CHF	x	x				2 Guarantors: must be employees of UN or Ministry of Health or Education
UNRWA	x	x	x			Combination of all three
Alrafah	x	x	x	x	x	Additionally, accepts gold, land, cards, cash, shares, stock – hope to use equipment, tools, animals if they are registered.

4. Summary of Islamic Banking Practices in WBG

Islamic banking is a term for the system of banking or banking activity that is consistent with Islamic law (Sharia) principles and guided by Islamic economics. There are two main principles of

[59] No information was available on YMCA's collateral requirements.

Islamic banking:

1. The prohibition of usury, the receipt and the payments of interests, known as "Riba" in Islam.
2. The prohibition of investments in businesses that contradict Islamic rules, known as "Haram" such as alcohol, pork or gambling or any business from which income deprives from any prohibited business.

Under Islamic rules any funds employed by Islamic banks/MFPs should be earned by way of profit from commercial risk where the bank and the customer share the risk. In addition, under Islamic rules money should be invested in a profitable way to increase the wealth, as the idea that money has the ability to rise in value if used for a period of time is prohibited.

Mudarabah (Profit Loss Sharing)

Mudarabah is a form of agreement between a bank ("Mudareb") and the customer where the customer subscribes to a Mudarabah fund at the bank, and the bank invests in an appropriate venture and uses its expertise and professional skills to manage the investment. The profit will be distributed between the bank and the customer according to the agreement. The bank deducts charges and fees for managing and controlling the investment. Shares in Mudarabah funds can be traded at stock markets.

Mu rabahah

Murabahah is the cost-plus method which is used commonly by Islamic banks/MFPs. The basis of Murabahah is that the bank buys asset/goods at the request of the customer and then sells it to the customer with a profit (fee) which will be agreed on in the main agreement between the two parties. The profit is considered as a compensation for the bank for the time and the work it did within the terms of the agreement. In this manner the bank will take the risk of purchasing the goods and will hold the title of the goods until it resell it to the customer; therefore, it is not prohibited. Murabahah is usually used for the purchase of physical assets (equipment, land, etc).

Ijarah

Ijarah is the equivalent term for lease or rent. In general Ijarah means the selling of a benefit or use or service for a fixed price. The Ijarah reflects an agreed profit between the bank and the customer, where the bank purchases the asset in question and rents the asset to the customer at a fixed price. All payments of rentals are treated as payments of operating expenses and are therefore fully tax-deductible. Leasing therefore offers tax-advantages to profit making MFPs. The lessor is obliged to retain responsibility for maintenance and insurance of the leased asset. There are many types of equipment which become obsolete before the end of its actual economic life. This is particularly true of technology equipment like computers. This risk is passed onto the Lessor who will undoubtedly charge a premium into the lease rate to compensate for the risk. A Lessee may be willing to pay the said premium as an insurance against obsolescence. If the equipment use is for a relatively short period of time, it may be more profitable to lease than to buy.

Ijarah-W-al-Iktina (Lease purchase contract)

A contract under which an Islamic bank/MFP leases or rents goods or assets to the customer ("the lessee") for an agreed price, and at the end of the lease period, the bank transfers the title of the goods or the asset to the customer. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease.

Istisna'a

An Islamic institution places an order with a contractor to build, say, a factory or other fixed price turn-key project. The Islamic bank then agrees to sell on the factory to a project company on differed payment terms. Typically, the Islamic investor then either continues to own the factory and charges the user fees based on the profitability of the factory, or sells the factory back to the project company on differed payment terms. The advantage to this financing method over, say, a Murabahah, is that start-up costs (e.g. earth removal) may be included in the fee to the user or the purchase price. Both the type of asset being purchased and the purchase price/user fee must be known at the outset.

Musharakah (Joint Venture)

Musharakah is a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in a joint business. With this product, an Islamic banking institution establishes a special purpose company with its customer to finance the new venture. Both parties are entitled to participate in management, but these days Islamic banks generally play little or no role in the joint venture management. There is a risk that the joint venture may fail and there is no guarantee that a profit will be generated. If there is profit, it will be distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

Bai bi Salam (pre-financing)

Bai bi Salam is a financing transaction where the buyer pays an advance payment for goods to be delivered in the future, and the seller undertakes to supply the specific goods to the buyer at a future date in exchange of the advance price that was paid at the time of the agreement. The quantity and quality of the commodity intended to be purchased and workmanship should be clearly determined without any ambiguity.

Bai bi Salaf

Bai bi Salaf holds the same principles of Bai bi salam, the only technical difference between them is that in Bai bi Salaf it is neccesary only to refer to the goods or service to be exchanged in general terms, meanwhile, in Bai bi Salam the specific identification of the goods/services should be clearly determined at the time of the agreement.

Musaqat and Muzara'a

In this method the Islamic bank/MFP finances agricultural development and products, while the farmer supplies the land, labor, and farm management. Both parties will share the resultant profits or losses. Musaqat is the term used for financing of irrigation and cultivation work. Muzara'a is the term used for financing agricultural implements such as water pumps, tractors, fertilizers, etc.

Qard Hassan (Good Loan)

Qard Hassan is a true interest-free loan. This loan is extended on a goodwill basis, where the debtor is only required to repay the amount borrowed without any interests to the creditor or compensation for the time or value of the borrowed money.

Muqarada

Muqarada is the issuance of bonds or certificates by an Islamic bank to finance a specific project. The holders of the bonds have the right to share the profits earned by the project but have no voting rights.

Wadiah (Safekeeping)

In Wadiah, a bank/MFP is the keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the amount, when the depositor demands it. The depositor, at the bank's discretion, may be rewarded with a hiba (gift) as a form of appreciation for the use of funds by the bank. In this case, the bank compensates depositors for the time-value of their money (i.e. pays interest on savings) but refers to it as a gift because it does not officially guarantee payment of the gift.

Joalah

This is simply the payment of a fee for the rendering of a service.

Annex 4

Laws that Affect and Enable Microfinance in the WBG

Law (in force/ draft)	Updates	Brief Summary/Relationship to Microfinance Issues	Recommendations
Microfinance Law (draft)	Draft prepared by EU consultants in 2004	This first draft law that provides a regulatory framework for microfinance. The draft regulates microfinance services, loans, collateral, and PMA oversight and supervision. The draft law provides rules for establishing a microfinance association. Primary legal instrument for the regulation of microfinance. PMA is currently developing a set of more appropriate regulations.	Review and revise into regulations as per the current draft regulations being developed by the PMA. Consider a PA Policy Statement instead of a Law for Microfinance to clarify the role, functions and operations of microfinance and how it contributes to economic development in WBG.
Commercial Law 1966 West Bank; Ottoman Commercial Law 1266H Gaza Draft Law harmonizing WBG pending before the PLC	Draft pending for 4 four years before the PLC.	The laws and the draft set out the rules for commercial activities, a commercial registry for merchants, commercial contracts, commercial paper, pledges, and corporate and personal bankruptcy. Regulates pledges of collateral which is a primary tool that enables microfinance.	Review the draft law and press for adoption by PLC Today, laws can be issued by Presidential decree which is a power the President can exercise during emergency. However, the law requires significant review with respect to pledges. Rules for pledges in this law should be reconciled with the draft Secured Transactions Law.
Companies Law 1964 West Bank; 1929 Gaza	Draft law pending before the Cabinet; discussions are underway to issue the law by presidential decree	The laws regulate the registration of companies and partnerships. The laws in general cover: registered capital requirements; number of shareholder required to incorporate companies, shareholder rights; board of directors and responsibilities; corporate structure changes; registration of foreign companies; penalties and duties of directors; company wind up procedures; and liquidation. Relates to microfinance in terms of incorporation of businesses that offer microfinance services.	Review the draft law for consistency with other laws. Adopt one harmonized law for both West Bank and Gaza. Advocate for the option of registration as non-profit company to be included in the current draft. Provide swift rules for the incorporation of MFPs.

Law (in force/ draft) contd.	Updates	Brief Summary/Relationship to Microfinance Issues	Recommendations
Secured Transactions Law	Draft pending before the PLC.	The law regulates transactions in order to secure an obligation with collateral, including pledges; conditional sales; sales with retention of title; mortgage of movable property; assignment of accounts or claims; consignment of goods; the sale of accounts; secured sales contracts; and leasing of goods. The law also sets rules for collateral interest and secured obligation, perfection of collateral interest, priority of collateral interests and interests of lien holders, the registry of collateral interests in movable property, and enforcement of collateral interest. Enacting this law would enable lenders to take various forms of collateral and register it; it offers an opportunity for the lender to attach and seize collateral through self-help mechanisms without getting held back in courts of law.	Enact the draft law and establish the registry of movable assets.
Civil Procedures Law Law No. (2) of 2001.		Provides the procedural steps for litigation, such as court jurisdiction and authority, venue, filing of a complaint and an answer, pleadings and motions, notices, trial, and the appeal. This law applies when an MFP wants to attach collateral in the event of default. A court order is required for execution. This gives rise to defenses that the borrower may raise, thus delaying the attachment and seizure of collateral.	Introduce expedited procedures for micro-finance litigation based on self help principles and a waiver of defences in cases of default on a collateralized loan agreement.
Execution Law Law No. (23) of 2005.		This law provides rules and procedures for the execution judgment related to foreclosures, attachment, seizure and enforcement.	Review all steps related to time delays and the right of the defendant (borrower) to present challenges during enforcement.
Income Tax Law Law No. (17) of 2004.		The law sets the rules related to corporate income tax issues; NGO income is exempt from taxation.	Income for MFPs registered as NGOs is tax exempt. Registration as a corp-orate entity as will be required by PMA in the new regulations will require MFPs to pay up to 15% income tax.
Majelleh (Civil Code)		Ottoman *Majelleh* dated 1293 *Hijri* Regulates pledges, guarantees, contracts, attachment and seizure	Given the dated period during the *Majelleh* was issued, it will be important to update principles related to pledges, attachment and seizure.
Public Notaries Law		Law 11 of 1952 (West Bank) and no (34) of 1919 in Gaza; attachments.	Reduces notarization fees.

Annex 5

PMA Restrictions on Bank Provisioning

For debt provisioning purposes, banks shall follow the following instructions:

Traded securities shall be value accordingly:

1. **Shares of national companies** traded at the Palestine Securities Exchange shall be valued at %50 of the market value.
2. **Shares of foreign companies** traded at Arab and foreign securities exchange shall be valued at %50 of the market value.
3. It is conditional that the shares were pledged in accordance with the law for the benefit of the bank and that the client had authorized the bank to sell the shares at any time to satisfy the debt.
4. **Real property collaterals (lands and buildings):**
   a. Real property registered at the Land Authority and owned by the customer, the acceptable percentage will be either the value of the deed or appraisal whichever is less as follow:
      i. 70% for the first two years of default.
      ii. 50% for the third year, new valuation should be carried out (less than two years)
      iii. 35% for the forth year, new valuation should be carried out and the client should be vigorously pursed by the bank and through judicial system for collection of the debt. .
      iv. 20% for the fifth year, new valuation should be carried out and the client should be vigorously pursed by the bank and through the judicial system for collection of the debt.
      v. 0% after the fifth year.
   b. Real property registered at the land Authority whose ownership is owned by more than one person (mortgage of one or more than one share of the property), the accepted percentage will be calculated either according to the value of the deed or the appraisal whichever is less as follow:
      i. 40% for the first three years of default.
      ii. 20% for the forth year, new evaluation should be carried out.
      iii. 10% for the fifth year, new evaluation should be carried out and the client should be supervised by the bank and the judicial system for collecting the dept.
      iv. 0% after the fifth year.
   c. Real property that are not registered at the Land Registrar (Irrevocable Powers of Attorney), the accepted percentage will be according to the value of the deed or the appraisal, which ever is less as follow:
      i. 30% for the first two years of default.
      ii. 20% for the third year.
      iii. 10% for the fourth and the fifth years (new valuation must be carried out)
      iv. 0% after the fifth year.

   A second or more mortgages may be taken provided that it has priority as the first mortgage for the benefit of the same bank and provided that the estimated value shall be sufficient to cover the total value of the mortgage.

   Collateral will not be accepted for the calculation of provisioning if five years have lapsed from the date of default and the same shall apply in the case of debt rescheduling.

5. **Vehicles, machinery and equipment:** the accepted percentage is 50% of the insurance policy or the market value whichever is less for the first two years of default, and 25% for the third and the fourth years provided that all pledge procedures were properly completed and have insurance polices issued in favor of the bank. For provisioning purposes, the collateral will be eliminated.
6. The amount of provision shall be determined after deducting the accepted collateral from the principle.
7. Facilities issued by bank whose capital is less that than that required by the PMA shall not be accepted for provisioning purposes.
8. **Precious metals** shall be valued on a monthly basis subject to price set at the international market.

Source: PMA Regulations for Banks

Annex 6

Examples of Collateralized Agricultural Financing in WBG[60]

1. Pre-financing and Collateralized Receivables, Gaza

Growers/farmers of strawberries and carnations in Gaza get all the inputs required for growing and exporting the agricultural produces from the local Gaza cooperatives on credit bases, and they pay back to the cooperatives after the export season is over. Farmers sign contracts for export for their agricultural produces with the cooperatives, and the cooperatives in turn sign contracts with Israeli exporting companies such as AGREXCO. In the contracts, usually the maximum exporting quantity of produces is pre-defined but the prices are determined on a weekly basis during the export season. The local cooperatives get their required materials either directly from Israeli suppliers or from local suppliers who, in turn, got these materials from Israeli suppliers.

Inputs are divided as follows:

1- Seedlings (mother plants for strawberries and carnations); the cooperatives got the seedlings from certified nurseries in Israel. The cooperatives pay with post-dated checks that will be due during the export season with guarantees from the Israeli exporting companies (AGREXCO and ARAVA for Strawberries and cherry tomatoes, and AGREXCO and Direct Flower for carnations).
2- Pesticides, fertilizers, plastic sheets for the tunnels for strawberries; most of theses items are purchased from local suppliers on credit bases. The local suppliers also get these items from Israel on credit bases.
3- Packaging materials for produces (carton, plastic boxes, labels). These materials are provided by the Israeli agricultural exporting companies; such as AGREXCO, ARAVA, and Direct Flowers, on credit bases just before the export season starts. The values of these materials are deducted later by the Israeli companies from the revenues from the Palestinian produces sales in outside markets.

When the cultivation season starts, farmers export their produces through the local cooperatives that take care of all the logistics issues until the produce exits Gaza through Karni crossing. Usually, the cooperatives inform the Israeli exporting company of the expected quantity of produces that will go out from Karni the next day, and the Israeli exporting companies inform the Israeli authorities of the expected number of trucks that will be leaving Karni during the designated day.

During the export season, and on bi-weekly bases, the Israeli exporting company transfers to the cooperative part of the revenues from their sales for the export produces after deducting their costs, part of the packaging materials costs, and their commission. They also withhold part of the revenues as a guarantee for the materials the cooperative had under the exporting company guarantees.

When the export season is finished, the cooperative and the Israeli export companies conduct the

[60] Sabri, S. (2007). Commercial patterns for Growing and Exporting Strawberries and Carnations in the Gaza Strip. USAID/PAPA program, Ramallah, West Bank.

financial reconciliation and the Israeli company pays the cooperative all the remaining balance after making sure that the cooperative has already paid their liabilities to the other Israeli suppliers. The cooperatives do the same reconciliation with each individual farmer and pay him the balance after deducting his debt to the cooperative.

2. Lease-based Finance of Agricultural Production in the Jordan Valley

The PAPA project met with the Sinokrot Food Company in April 2007 to develop the concept for supporting high-value, small-farmer agriculture development in the Jordan Valley. This meeting concluded that:

- Jordan Valley's unique microclimate for "off-season" production of cherry tomatoes and sweet peppers is a natural comparative advantage to exploit in order to develop profitable enterprises for small farmers.
- The economics of the natural comparative advantage is driven by the harvest cycle which occurs during the winter months of November through April, a time when these products are in greatest demand and bring the highest prices in other areas of the West Bank, Israel and Europe.
- Many local small farmers have good basic production skills. However, the major constraint is the small farmers' ability to properly package and distribute products to the markets where their products are most in demand.
- Sinokrot Food Company, a PAPA partner, could fill this marketing void through its exclusive marketing agreement with ARAVA Export Growers Ltd., a leading Israeli distribution company for fresh vegetables.
- Seeds and seedlings will be provided by an Israeli nursery located in the Jordan Valley.
- Small farmers also need access to agricultural advisors who can provide information on what types of plants to grow, plant health practices, and harvest and transportation methods.

After this meeting, the USAID/PAPA developed a project to assist the small farmers. The key features of the program are listed below:

- PAPA selected 300 small farmers in the Jordan Valley through open competition to participate in the program and thus receive assistance from the PAPA project. To qualify for the program, small farmers had to have:
    - Land and access to water;
    - Past farming experience;
    - Capital for cost-sharing the procurement of greenhouses; and
    - Capital for crop inputs, such as seedlings etc.
- It was agreed that the selected farmers had to provide 100% of the cost of inputs (seeds, seedlings, fertilizer, water, etc.) which could be accessed on pre-financing terms; 100% of the labor and management to operate the greenhouses; and 20% of the cost of the greenhouses. PAPA in turn provided 50% of the cost of the greenhouses as grants to the farmers.
- PAPA then took contact to a local financial institution to enable farmers to access credit for the remaining 30% of the greenhouse cost. A loan scheme was agreed with Alrafah Microfinance Bank for a total of 215 farmers. Alrafah provided group loans of up to US$ 5,000 with up to a 2-year term and 3 months grace. The loans were collateralized with the green houses, which remain in Sinokrot's ownership until the loan to Alrafah has been repaid by the farmer.
- Farmers also benefited from grant assistance from PAPA to develop up to 5 dunums (5 $km^{2)}$ of land for cultivation. PAPA's assistance was about $5,000 per dunum of greenhouses, with a maximum benefit of $25,000 going to any individual farmer. In addition, PAPA provided agricultural extension advisors for the first growing season so farmers would select plant types

and use growing methods that are market responsive, as identified by Sinokrot Food Company and ARAVA.

- All participating small farmers signed a marketing contract with Sinokrot Food Company, guaranteeing sale of their produce via Sinokrot. Sinokrot constructed a sorting and packaging plant in the area which serves as the hub for the integrated support program.

Key summary statistics of the program:

1. PAPA greenhouse assistance budget — $1.5 million
2. PAPA agriculture extension budget — $0.5 million
3. Small farmers own funds for greenhouses — $0.6 million
4. Alrafah financing for greenhouses — $ 936,000 in 215 loans during 1st cycle

   Collateral: Farmers' savings/capital investment in accounts; green house equipment
   Guarantee to Alrafah from USAID/SMART program: 70% of projected max. Portfolio at Risk ratio of 20% of outstanding loans at documented default after documented recovery efforts and claim letter.
5. Number of farmers participating in program — 300 farmers
6. Number of dunum of new greenhouses — 300 dunums
7. Tons of cherry tomatoes produced — 1,040 tons
8. Farm value of cherry tomato production ` — $ 1.425 million
9. Tons of sweet peppers produced — 1,368 tons
10. Farm value of sweet peppers produced — $ 1.7 million

Annex 7

Recommended Collateral Options for Selected Loan Types and Sizes

	Suggested Collateral For Micro and Small loan size ranges:		
For Type of loans:	US$ 200-2,499	US$ 2,500-4,999	US$ 5,000-1 5,000
Individual microenterprise (ME), asset finance	Character assessment, cash flow analysis, credit history. Leased asset	Character assessment, cash flow analysis, credit history. Leased asset, household goods, ME equipment, machinery, produce, gold, if available.	Character assessment, cash flow analysis, credit history. Leased asset, household goods, ME equipment, machinery, produce, gold, if available.
Individual ME, working capital	Character assessment, cash flow analysis, credit history.	Character assessment, cash flow analysis, credit history. Household goods, ME vehicles, equipment, tools, if available	Character assessment, cash flow analysis, credit history. Gold, HH goods, ME input, inventory, output/produce, vehicles, equipment, tools, receivables.
Individual, consumer loan	Character assessment, Personal guarantor, credit history. Hire-Purchase/lease	Character assessment, Credit history. Leased asset, gold; HH goods; vehicles, equipment, tools.	Character assessment, Credit history. Gold; Leased asset, HH goods; Vehicles, equipment, tools.
Individual, home improvement	Character assessment, credit history	Character assessment, credit history. HH goods, machinery, vehicle, equipment, tools, gold.	Character assessment, credit history. House mortgage; HH goods, machinery, vehicle, equipment, tools, gold.
Individual, agricultural	Character assessment, credit history, cash flow analysis. Livestock; ME output/ receivables, ME input	Character assessment, credit history, cash flow analysis. Livestock; ME output, ME input (pre-finance)	Character assessment, credit history, cash flow analysis. Leased asset, livestock; ME output/receivables, ME input (pre-finance)
Group loans ME/business/ agricultural	Group self-selection, age/size/location of group, type and performance of MEs, cash flow. Group guarantee.	Group self-selection, age/size/location of group, type and performance of MEs, cash flow (Group rating). Group guarantee plus group savings.	Group self-selection, age/size/location of group, type and performance of MEs, cash flow (Group rating). Group guarantee plus group savings - graduate to individual loans.

Annex 8

Proposed Timeline for Actions Recommended by Study (see section 5)

	Immediate/short term: Jan-Dec 2008	Medium term: Jan 2009 – Dec. 2010	Long term: Beyond 2010
Retail level: MFPs	- Adopt a wider range of collateral options (recommendation #1) - Contract expert TA to review design and implementation of group lending methods, adapt and resume Increase use of the notary deed	Conduct market study and pilot test of micro-leasing	Improve credit risk management
Meso level: Industry	Training for MFPs on credit risk management Educating judges Advocating adoption of the draft secured transactions law	Supporting political risk insurance Streamlining legal representation and establishing a legal unit at the MFP Network and legal clinics to assist and educate borrowers Working on establishing a special police unit dedicated to enforcement	Creating closed-user group credit information for MFPs
Macro level: Authorities	Establishing self help principles Waiving legal defences	Strengthening lender's interests in movables by establishing an official register Advocating the use of possessory interests in movables and "limited assignment" option	Reforming the legal framework to provide legal standards for creating enforceable collateral interests in all kinds of business assets Ensuring that the draft Companies Law includes the registration option of non-profit companies

Annex 9

Portfolio Losses due to political risks of Palestinian PNSMF-member MFPs[61]

As at end September 2006

MFI	Deaths	Value $	Imprisoned	Value $	Property Destruction	Value $	Total incidents	Total Value $
ACAD	4	3,598	5	7,453	4	9,909	13	17,362
YMCA	6	20,597	10	37,357	20	100,334	36	207,347
PARC	7	8543	11	11,415	19	23,786	37	43,744
PDF	7	61,507	2	12,763	9	106,741	18	181,011
ASALA	4	2,880	0	0	50	23,441	54	26,321
UNRWA	28	20,721	12	7,049	323	263,748	363	291,518
ANERA	0	0	0	0	0	0	0	0
CHF	0	0	1	13,000	0	0	1	13,000
FATEN	0	0	0	0	0	0	0	0
Totals	56	117,846	41	89037	425	527959	522	780,303

As at end June 2007

MFI	Deaths	Value $	Imprisoned	Value $	Property Destruction	Value $	Total incidents	Total Value $
ACAD	4	3,598	5	7,453	4	9,909	13	20,960
YMCA	11	40,409	12	149,623	40	149,623	63	339,654
PARC	22	32,603	58	40,645	108	100,580	188	173,828
PDF	7	61,507	2	12,763	9	106,741	18	181,011
ASALA	4	2,880	0	0	50	23,441	54	26,321
UNRWA	8	5,213	1	476	20	12,258	29	17,947
ANERA	5	32,000	4	19,000	12	55,000	21	106,000
CHF	4	16,700	3	22,000	0	0	7	38,700
FATEN	0	0	0	0	0	0	0	0
Totals	65	194,910	85	251,960	243	457,552	393	904,421

[61] As provided by the Palestine Network for Small and Microfinance, October 2007.

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2. Annotated Bibliography

2.1 Bibliography on Collateral Assets as International Best Practices

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The authors profile the various intersecting fields in the collateralization of loan contracts. The fields include the development of national financial sectors to the promotion of microenterprises as a catalyst for poverty alleviation. Tying together conceptual and field work on collateral law and substitution, the authors put forth a set of policy recommendations that aim at removing the important obstacles in the access of the poor to financial services.

Brandsma, Judith. Microfinance in the Arab World: Shaping the Industry's Future. First Annual Conference of SANABEL, Microfinance Network of Arab Countries. The Third Microfinance Survey in the Arab World, Preliminary Results, 2002.

This is a power point presentation illustrating the results of a qualitative and quantitative questionnaire where basic data of MFIs was gathered in selected Arab countries, stating that MFIs together control 90% of the market and 11 MFIs are fully financially sustainable and serve 80% of all active clients. The presentation further identifies MFIs which are legally allowed to make a profit, key management changes that have taken place, statistical charts of active borrowers and key findings concerning clients, processing times and financing growth rates.

Bond, Philip and Ashok Rai. Collateral Substitutes in Microfinance. Northwestern University, July 3, 2002.

The authors examine two commonly used forms of collateral substitutes used by MFIs operating in developing countries: social sanctions and credit denial. These collateral substitutes are seen as punishment mechanisms for clients that default on their loan repayments but the authors make the argument that they are not quite perfect substitutes for traditional forms of collateralizable assets. They argue that MFIs that impose social sanctions and/or credit denial face the challenges of responsibility delegation, social disunity and adverse selection.

Consumer Protection Principles in Practice: A Framework for Developing and Implementing a Pro-Client Approach to Microfinance. The SEEP Network, Progress Note, No. 14, October 2006.

The note stresses how the SEEP Network has taken a lead and active role in furthering pro-client policies for its member organizations in order to improve and strengthen practices and standards in the Microfinance industry. The Progress Note presents the experiences of SEEP members over the last couple of years and how they have implemented their own policies and codes to further Microfinance objectives. Such policies have created a framework for developing and implementing pro-client principles by MFI, associations and networks.

Emerging Lessons in Agricultural Microfinance: Selected Case Studies. CGAP/IFAD, August 2006.

This publication examines case studies from Bolivia, Peru, Kyrgyzstan, Mozambique and Kenya in order to offer insight and present lessons learned in the field of rural and agricultural microfinance. The case studies reflect the general constraints and challenges in agricultural finance, including the issue collateral for agricultural loans, but present innovative solutions that can hopefully be scaled up and replicated in other parts of the world.

Klinkhamer, Madeline. Microfinance Housing Products and Experience with Land Titles as Collateral. The Group for Housing and Infrastructure Financing, Inc., June, 2000.

Examines how different MFIs have used non-movable assets as collateral for a variety of forms of housing loans. Explores issues related to collateralizable assets and transaction costs, loan size, group vs. individual loan methodology and the lack of cost benefit analyses in the microfinance industry for housing loans.

Kugler, Maurice and Rossela Oppes. Collateral and Risk Sharing in Group Lending: Evidence from an Urban Microcredit Program. CUEC working paper, Oct. 2005, http://www.microfinancegateway.org/files/31655_file_37.pdf

This paper illustrates the role of collateral in mitigating groups default. It suggests that while diversification within groups facilitates risk pooling, it also increases expected bailouts or group default costs for low risk borrowers. Using data collected from a group lending program in Benin, they authors argue that collateral helps to offset and alleviate potential negative spill overs from group default induced by membership of borrowers with risky projects. They conclude that the presence of borrowers with collateral facilitates access to credit for group members without collateral, who in turn provide insurance against group default.

Lessons Learnt the Hard Way, CGAP Working Group on Microinsurance – Good and Bad Practices, Case Study No. 6, ICMIF-January 2005.

This report uses a series of case studies to identify good and bad practices in Microinsurance for practitioners which relate to insurance products and delivery models, research on issues such as the regulatory environment for microinsurance and instructions on how to support innovations that will expand and enhance the availability of appropriate microinsurance products. The report also provides donor guidelines for funding microfinance.

Nagarathan, Geetha and Justyna Pytkowska. Deepening Microfinance Outreach to the “New Poor” in CE, EE and NIS Region: Profile, Performance, Practices and Projections. June 2002. http://www.mfc.org.pl/mfc_rc/downloaded_docs/Poverty_Outreach.pdf

This paper looks at the increase in poverty amongst many Eastern European countries since the collapse of the Soviet Union and how MFIs have introduced various financial products to meet the financial needs of the “new poor.” Many of these MFIs have allowed alternative

sources of collateral from their clientele in order to utilize what limited security assets they possess in order to access loan capital.

Savavian, Mehrez. Heywood Fleisig and Jevgenis Steinbuks. Unlocking Dead Capital: How Reforming Collateral Laws Improves Access to Finance. The World Bank: Private Sector Development, March 2006, http://rru.worldbank.org/publicpolicyjournal

The authors attack the rigid legal and regulatory environments in many developing countries that prevent MFIs from offering their clients innovative alternatives in the collateralization of loan contracts. By allowing clients to put forth movable forms of collateral, such as household items, work machinery, livestock, warehouse receipts and accounts receivable, MFIs can "unlock" the unused capital assets that their clients possess. The paper focuses on case studies in Romania and Albania.

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This Technical Brief clearly defines the principles behind secured lending as well as the characteristics of movable and immovable collateralizable assets. It describes the mechanics and preconditions necessary for the development of an enabling environment for secured lending as well as best practices in registering and enforcing collateral agreements.

2.2 Bibliography on the Microfinance Industry in the West Bank and Gaza Strip

Abboushi, Reem *The Palestinian Network for Small and Microfinance (PNSMF), Microfinance in the Middle East (Palestinian Context).*

This power-point presentation provides an overview on the nine Palestinian members of the non-profit microfinance institutions which compose the members of the PNSMF. It provides cumulative statistics concerning active clients, outstanding portfolio's and portfolio's at risk in the West Bank and Gaza, priorities of donors in Palestine, legal environment for MFIs, capacity building needs, urgent needs and how MFIs are responding to ongoing crises in the territories.

ANERA Gaza Women's Loan Fund (GWLF) Culture and Free Thought Association Diagnostic, USAID SMART: Small and Microfinance Assistance for Recovery and Transition. February 2007.

The loan appraisal report written by the USAID SMART Program details GWLF's financial standing where despite operating in a difficult environment, it has had the ability to implement a successful guarantee scheme. The report considers GWLF's proposal which includes two requests by performing a valuation on whether its microfinance portfolio could develop its skills in facilitating access to women and its ability to create a sustainable and professional portfolio to microfinance providers.

FATEN Microfinance Performance Assessment, Planet Rating, February 2006

This is a report concerning Palestine for Credit and Development (FATEN), an independent not-for-profit organization dedicated to providing micro-finance services to Palestinians, both individual and group loans to its clients through a network of twelve branches throughout the West Bank and Gaza Strip. Although, FATEN is one of the strongest Palestinian MFIs and received a rating range of "B-to B ", it still must identify a developed Strategic Plan to continue to grow highly achievable revenues and to maintain its sustainability status quo.

Initiative for a Sustainable and Accessible Microfinance Industry in the West Bank and Gaza: Final Report. A Task Order Under the SEGIR Financial Services IQC, January 2001-February 2004.

The report addresses the benefits of microfinance in advancing financial development and entrepreneurship in developing countries. The report captures the work of a three year project funded by USAID managed by the Initiative for a Sustainable and Accessible Microfinance Industry (ISAMI) sought to lay the basic groundwork for sustainable micro-lending services in the West Bank and Gaza. The report offers significant lessons for future microfinance initiatives in the Palestinian context.

Khaled, Mohammed. Kate Lauer and Xavier Reille. Meeting the Demand for Microfinance in the West Bank and Gaza Strip. CGAP, January 2006.

This report provides an analysis of the Palestinian economy and financial system in the West Bank and Gaza Strip. It describes the role of the microfinance industry in providing financial services to the poor and the challenges in constraints facing the industry in carrying out this role effectively and in a sustainable manner. It concludes by making a set of policy recommendations for donors and other stakeholders in the region

Microfinance Market Survey in the West Bank and Gaza Strip. Conducted by Planet Finance, May 2007.

This market survey focuses on the financial needs of the Palestinian micro entrepreneurs which have been rapidly changing in the light of the financial, political and economical crisis affecting the Palestinian Territories. The survey contains a summary of the results, a summary on the main findings, and a detailed market analysis of microfinance in the West Bank and in the Gaza Strip and provides valuable recommendations for MFIs donors and other relevant networks in the development of new microfinance products as well as on the regulatory framework for microfinance.

The Palestinian Network for Small and Micro Finance Plan 2006-2008.

The document provides the planned activities for 2006-2008 for members of the Network which includes effective targeting of goals and upcoming events. The document also revises the Network's vision and mission by focusing on areas that will strengthen the capacities of the Network to deliver effective micro and small credit services for the support of enhanced market development.

Rural Economic Empowerment Foundation (REEF) Business Plan 2007-2009. Palestinian Territories. June 2007

This document provides a brief history of the Palestinian Agricultural Relief Communities (PARC) and the institution's rationale for making the transition to REEF. The plan describes the organizational structure, main objectives and marketing strategy REEF will adopt over the coming years in its effort to become a leading provider of sustainable microfinance services in the Palestinian Territories.

UNRWA MMP Microfinance Performance Assessment, Planet Rating, April 2006

This is a report concerning the Microfinance and Micro enterprise Program (MMP) which is a department of UNR WA which initially joined microfinance lending in order to target women in Gaza. It has operations in Palestine, Jordan and Syria dedicated to serving poor Palestinian population. The report demonstrates why the MFI has received a "C" global rating due to operating under conflict conditions in Palestine and also reflects MMP 's improved ability to protect its margins in the local market context.

West Bank and Gaza Strip Investment Climate Assessment: Unlocking the Potential of the Private Sector. The World Bank Finance and Private Sector Development Group, March 20, 2007.

This report provides a background to the current state of the Palestinian economy while examining the structure and performance of the industrial sector in the West Bank and Gaza Strip. The report exposes the major legal, financial and market constraints affecting the investment climate in the Palestinian territories. It concludes by providing a set of recommendations on how to improve the investment climate and further develop the capacity of Palestinian enterprises.

YMCA-SED Microfinance Performance Assessment, Planet Rating, February 2006

This is a report on YMCA's Small Enterprises Development Program (SED) within its Extension Services Unit (ESU) which was established in 1992 to provide microfinance services to selected groups of vocational, industrial and polytechnic graduates in the West Bank and Gaza. The report demonstrates why the MFI has received a "D to C-" rating range and provides the necessary measures that must be taken in order for YMCA-SED to reach minimum requirements in terms of governance structures, business strategies and the ability to achieve long-term sustainability.

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Developing a Palestinian Roadmap for Legislative Reform in the Business Sector: Policy Options and Recommendations. Al-Mustakbal Foundation for Strategic and Policy Studies, September 2006.

This paper seeks to advance development efforts in the West Bank and Gaza Strip by promoting legislative reform in the Palestinian business sector. It examines the causes of the *legislative and regulatory problems that have restricted business activity in the Palestinian Territories while providing recommendations on how these problems may be overcome.*

Fayyad, Salam. Prime Minister Delegate. Platform of the 13th Government of the Palestinian National Authority, July 22, 2007.

This is the speech of the Prime Minister, to present the 13th Palestinian government's platform which highlights the reasons why this government came about following the expiry of the state of emergency and the issuance of the presidential decree on July 13, 2007. The speech addresses the government's plans to revitalize institutions and the economy by creating jobs, increasing the competitiveness of available services and products, promote the management of development projects and coordinate such efforts with economic institutions and private sector representatives to achieve the goals of a balanced socio-economic development.

Press Release on Labour Force Survey Results. Palestinian Central Bureau of Statistics, June 2007.

The report is based on the Labor Force quarterly survey where 6,553 questionnaires were completed out of 7,552 households to represent the Palestinian society conducted in the early months of 2007. It focuses on the economically active Palestinians, providing statistical analysis of employment and unemployment rates as well as participation in formal and informal markets. It provides statistics in the West Bank and Gaza Strip regarding percentage of participants in the labor force, unemployed persons, concentration of unemployment, net wages of employees, average daily work hours and the economic dependency ratio in the Palestinian Territories. The report also provides statistical information concerning employment in Israel and Israeli settlements.

Stagnation or Revival? Israeli Disengagement and Palestinian Economic Revival. The World Bank. December 1st, 2004.
http://siteresources.worldbank.org/INTWESTBANKGAZA/Resources/WBG-Overview-e.pdf

This report looks at the implications of Israel's disengagement strategy and its potential impact on the Palestinian economy already suffering under burden of the 2nd Intifada. It also examines the Palestinian Authority's strategy for long term economic recovery in the West Bank and Gaza Strip as well as the important role of international organizations in the rebuilding process.

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http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/WESTBANKGAZAEXTN/0,,menuPK:294370~pagePK: 141 159~piPK: 1411 10~theSitePK:294365,00.html

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   b. Bankruptcy Law 1936
2. Palestinian Monetary Authority Law 1997
3. Banking Law 2002
4. Capital Market Authority Law 2004
5. Income Tax Law 2004
6. Investment Promotion Law 1998
7. Amended Basic Law 2003
8. Charitable Associations and Civil Society 2000
9. Companies Law 1964 (West Bank)
10. Companies Law 1929 (Gaza)
11. Income Tax Law 2004
12. Execution Law 2006
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