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PALESTINE

UNRWA Scoping Study

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*September 2007*



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## 1. Executive Summary

MMD is now at an important phase of its development. It has been operating as an agency of UNRWA for the past 16 years and has reached the limit of its abilities under the current operating structure. Compounded by the recent escalation of the political and economic crisis, MMD is in fact regressing in outreach and sustainability, at least in the Gaza Strip. However, despite this incredibly challenging environment, as in the past, this crisis will pass and MMD must have already begun to take the steps necessary to be ready to implement a carefully planned process for transitioning to a stable organization with a long-term vision that will better serve its clients far into the future.

There are a number of constraints in addition to the political and economic environment that help explain MMD has not grown as it could have and why it has not adapted as it should have. These factors can be affectively addressed through a transition process that will happen over a period of time.

The overriding rationale for making a transition rests on the following:

1. MMD's current inability to develop a **corporate culture** within its current structure. This is essential for changing the way that staff, management and even clients view MMD's services. Without cultivating a corporate culture, MMD lacks the operational coherence needed to develop high quality services that can meet the changing demands of its clients.
2. As long as MMD remains under UNRWA's umbrella, MMD will never be certain of its **long-term permanence**. As mentioned, earlier, without permanence, without access to an institution that is present in their community year in and year out over the long-term, a microcredit and savings program's clients cannot build assets and therefore cannot achieve a structural exit from poverty.
3. The absolute need for **management independence**. In order to be a successful microfinance provider must be able to quickly respond to the market. This means that management must have the ability to make quick business decisions that can allow branches to adapt products and processes as necessary to meet changing client needs and political and economic constraints. It also allows management to hire and compensate (salary and incentives) staff in timely and appropriate ways which will help strengthen operations and build greater long-term loyalty to the organization.
4. MMD is currently reaching a fraction of the tremendous **unmet demand** that exists in the market for microfinance products and services in the region. This unmet demand includes microcredit as well as savings. Transitioning into an independent, sustainable, financial service provider will allow MMD to grow in the ways necessary to meet this demand.

As such, the mission team proposes a phased approach that will allow for national transition under a regional framework. This phased approach would entail the establishment of a **non-deposit-taking shareholding company** under the prevailing companies' law to provide an independent legal house for the microfinance program. The value of this structure is that it would afford MMD management the kind of independence it needs to begin making the important changes to ensure greater efficiency and productivity of operations. During this phase, MMD can be taking the steps necessary (operational, legal, regulatory, etc..) for making the next transition into a regulated commercial deposit-taking institution.

At the same time that it is strengthening its financial position, MMD will need to develop a strategy for its transition, focusing first on the actions necessary for becoming a finance company. The strategy will then focus on the steps necessary for becoming a regulated bank in Palestine. An essential part of this

strategy will be assembling a transition team, which will be tasked with carrying out the research, preparation and execution of the transition strategy.

Once MMD begins the transition process, it will be stepping out of the status quo and will be stepping onto a path, which will lead to a more stable place where MMD will be able to better achieve its mission and to better serve its clients.

## 2. General Introduction

### 2.1. A Unique Microcredit Institution

Microfinance as a discipline is characterized by enormous amounts of literature from summarized monographs and pamphlets to brick sized books; from articles and essays to manuals and how-to-guides; publications of every size, color, type and shape characterize this ever-growing field. Yet in all of this discourse, it is rare to find a description of the overriding characteristic of microfinance: the enormous difficulty of carrying it out successfully. It is far from the scope of this report to describe in detail the difficulties one faces when implementing a microfinance scheme. However, suffice it to say that not only must one lend money often in unsafe environments and remote communities to impoverished landless and asset less people who lack a banking culture, but in order to be viable, one must carry out an inordinate number of these operations every day. One must also handle an obvious lack of tangible collateral and at the same time manage to collect all of these loans in a timely fashion. In addition, lest one be left without funds for on-lending, operating a microfinance program entails either towing the line of “international” bureaucrats; or enduring “social entrepreneurs” bankers, government licensing officials and the like; all the while covering financial and operating costs with the interest generated from the lending operations.

In light of the intrinsic difficulties of the trade, it is no exaggeration to say that UNRWA’s Microfinance and Microenterprise Department (MMD), operating as it does in spite of an on-going military occupation and a disintegrating social fabric, faces the most difficult environment and operating conditions of almost any microfinance program around the world.

### 2.2. Objective and Key Definition

The objective of this Scoping Study is to assess the strategic, legal and operational viability of the Institutional transition of UNRWA’s MMD from its present status as a not-for-profit project into a deposit-taking shareholding microfinance institution (MFI) in the Palestinian legal context. It is important to note that recently such a transition process has been occasionally called “institutional transformation”. In this report, the authors use the more traditional term “transition.” If the term “transformation” was used according to its basic meaning, “to change form”, then it would be adequate for what is being proposed in this report: changing MMD’s legal status from a not-for-profit subsidized project in order to adopt the form of a commercial institution, in fact a transformation, “a change in form”.

In its more accepted usage and meaning, however, the term “**transformation**” is understood as “**becoming something else**”, i.e. to change essence, to change at the core. For this reason, it is an inadequate term for the process that MMD is preparing to go through because precisely what MMD expects to carry out is neither a change of its core activity nor the core reason for doing it. On the contrary, the process will require major efforts to retain the mission and vision of the program. The purpose of this report is to analyze the viability of changing the way in which this core activity is done. What is proposed here is abandoning one operating strategy and adopting another, **going from** operating in a subsidized manner, to following a sustainable or profitable manner. For this reason, this report speaks of “**institutional transition,**” rather than institutional transformation.

Aside from this more theoretical consideration, there are two overriding reasons for choosing the term transition and both have to do with how the staff and the institution itself view the change. The first purpose is to convey that the upcoming experience is an evolutionary process, a day-to-day change rather than a sudden makeover. In addition, the shift from a not-for-profit or subsidized endeavor to a commercially driven operation, will require continuity so that staff do not interpret the change as an abandoning of the mission of their endeavor. Nothing can be more traumatic for microfinance staff than to suspect an abandoning of their previous efforts including their target clients. This concern was overwhelmingly evident during the initial sessions with MMD staff. Naturally, aside from choosing adequate terminology, the continuity of “transition” relates also to practical matters. For example, the unit created to write the business plan of the new commercial institution will likely transition to become its finance/treasury department and the group formed to improve operations transitions will become the R&D department of the institution, and so on. The point is that the essential condition of the whole process is staff acceptance, indeed staff buy-in. Nothing will disband staff more readily and throw the whole process into a tailspin than their perception that MMD is abandoning its mission.

### **2.3. Institutional Transition**

What is the reason then for MMD’s interest in changing legal status? Operating as it does as a subsidized department of a UN relief agency, MMD does not lack funds to cover either its operational costs to finance its portfolio, a major rationale for institutional transition. The overriding motivation for seeking this change is rather long-term permanence. Paradoxically, the protective umbrella is no guarantee of long-term permanence.

Long-term permanence is of course synonymous with sustainability; it is based on the ability to cover operational costs with the income generated by those very operations. In this respect, permanence is a question of efficient uses of resources (owned or borrowed), whomever they may belong to. Efficient use of resources presupposes a series of management and operating conditions. In the case of MMD, like all MFIs, efficient use of resources requires independent decision-making. This decision-making is simply the conditions and ability to make effective business decisions. One primary underlying rationale for MMD’s transition is that operating as it does under the UNRWA umbrella does not permit sound and efficient business decisions. Independent decision-making will allow MMD to adapt itself to its unusual market. Precisely because it works in such a uniquely challenging environment, MMD needs the kind of management and operating flexibility that could never achieve as the department of a UN relief agency.

There is an even more fundamental and underlying reason for MMD to seek independence. This reason has to do with the identity of the institution. It is the personality of the institution, its character, how it sees itself, and how that affects the way it does things. In short, it is its corporate culture. From something as fundamental as choosing its own name to something as complex as introducing a new product, from the way that the staff relate to their work to its loan recovery policy, independence, or autonomy if one prefers, will permit MMD to mold its own corporate culture and acquire a fundamental sense of identity necessary to better serve its market. Although originally an ideal incubator for MMD, UNRWA needs to support the MMD move on in order to respond to its need for long-term permanence.

## **2.4. Challenge of Transition**

Naturally, transition and the management and operational independence that it will give MMD are no guarantee for either sustainability or permanence. As has been mentioned, transition for transition sake is not the end goal. The end goal is sustainability for long-term permanence: to carry out an institutional transition and not make full and adequate use of the advantages that it will foster will bring neither sustainability nor permanence.

Once MMD starts to operate as an independent financial institution, it will face two new challenges: On the one hand, it has to make sure that it selects correctly the areas where changes need to be made and must be very thorough when making those changes, taking full advantage of its new management and operating independence. At the same time, it must understand those areas that are not to be changed, in order to protect them and assure their post transition continuity. It is a question of strategic selectivity, a key success factor for ultimately becoming a regulated deposit-taking financial institution.

### 3. Drivers of Change

#### 3.1. Background and Operating Environment

##### 3.1.1. MMD Current Operations

The Microfinance and Microenterprise Department (MMD) is an autonomous department of the United Nations Relief and Works Agency (UNRWA) for Palestine Refugees in the Near East. Based in Jerusalem, MMD began working with a Small-Scale Enterprise (SSE) product in Gaza and the West Bank in 1991 with a capital fund of US\$407,000 and moved into microfinance lending with launch of its solidarity group lending product (SGL) targeting women in Gaza in 1994. In 2003, MMD operations were expanded to Syria (a branch at the Yarmouk refugees' camp) and Jordan (a branch at the Wehdat refugees' camp). Currently, MMD operates six branches in West Bank, 3 in Gaza, 2 in Jordan (with an additional two branches planned for 2007); and 2 in Syria (with an additional two branches planned for 2007). MMD holds a unique position as it is part of the UN and functions as a multinational MFI with operations in three countries: Palestine (West Bank and Gaza), Jordan and Syria, each dedicated to serving poor Palestinians.

MMD currently offers five loan products:

- 1) Small-Scale Enterprise Credit Program (SSE) since 1991.
- 2) Micro-credit Enterprise Program (MEC) since 1996.
- 3) Solidarity Group Lending Program (SGL) since 1994.
- 4) Consumer Lending Program (CLP) since 2002 (was first piloted in one of the poorest areas in Jabalia refugees' camp in Gaza with a small fund of US\$50,000 from the 1999 AGFUND prize); and
- 5) Housing Lending Product (HLP) since 2006 in Gaza.

The MEC product is available at all branches. The SGL and CLP products are currently being offered in Gaza only. The SSE is available in the West Bank and Gaza with plans to introduce this product to Jordan and Syria in 2006. The minimum loan size begins at US\$ 100 for the SGL and reaches US\$ 70,000 for the SSE. As of June 30, 2007, the average loan outstanding was US\$ 718. The average portfolio term is eight months. Product APRs range from 16% to 31% in Gaza, from 22% to 27% in Syria, from 12% to 31% in Jordan and from 15% to 31% in the West Bank. Average portfolio APR is 23%. All loan disbursements are made by checks whereas loan repayments are made in cash through MMD cashiers in its branches and offices.

With an outstanding loan portfolio of USD\$ 7,183,938 (as of June 30, 2007), total assets of USD\$ 17,340,286 (June 30, 2007), a staff of 229 and an active client base of 12,351 (Dec. 31, 2006), UNRWA MMD is the largest microfinance provider in West Bank and Gaza. MMD holds this position, despite the fact that the program has shrunk from its position at December 31, 2005 with an outstanding portfolio of over USD\$ 9.1 million serving over 14,566 clients.

### 3.1.2. Performance

As of June 2007, and in terms of performance, operational self-sufficiency for the program is as follows:

1. Gaza: 39% down from 47% (December 2006).
2. West Bank: 109% up from 80% (December 2006).
3. Jordan: 99% down from 109% (December 2006); and
4. Syria: 91% down from 119% (December 2006).

For all 4 programs, operational self-sufficiency is slightly up at 70% as of June 2007 from 69% (December 2006). While portfolio quality has decreased dramatically in Gaza since the election of Hamas, the overall program portfolio quality has improved since December 2006, going from 33% PAR > 30 days down to 19% at the end of June 2007.

### 3.1.3. Uneven Growth

The unstable political climate has had a clear impact on UNRWA MMD operations, which experienced rapid growth between 1994 and 2000. By 1997, the program was fully operationally self-sufficient, covering its operational costs from its credit revenues. However, the beginning of the second intifada in September 2000 had a significant impact on the operations of MMD as the crisis spread throughout the small and microenterprise community. In 2002, the number of MMD's clients had plummeted from nearly 13,000 to less than 5,000 (1996 figures). Following this low point, the number of clients and portfolio outstanding continued to grow to a peak just preceding the 2006 election of Hamas (see section on the political climate). Since then the client levels have steadily declined, primarily in Gaza.<sup>(1)</sup>

In April 2006, MMD was rated by Planet Rating and received an overall score of "C" with a negative trend. The weakest areas evaluated, Activities (score of "d") and Efficiency and Profitability (score of "d") pulled down the fairly positive ratings given to Governance (score of "b"); Risk (score of "a") Information (score of "b"); and Financing and Liquidity (score of "c"). The lower scores reflect primarily the declining portfolio quality emphasized by the political instability. The higher scores reflect MMD's strong financial backing by the UN and its ability to protect its losses. They also reflect a strong risk management system with a high level of appropriate controls, including an effective internal audit system.

Some of the internal factors that have contributed to MMD's fluctuating performance include:

1. client vulnerability to their restriction of movement, checkpoint closures, changes in their ability to purchase goods, and non-payment of government salaries
2. loan products are, for the most part, not secured.
3. lack of portfolio diversification
4. uneven cash flow analysis resulting in higher loans issued to unqualified clients
5. decision to not reschedule/refinance loans (unlike what is done in other MFIs).

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1 A Transformation Scoping Study - UNRWA

Through interviews and observations, the mission team's brief visits to a selected number of MMD branches (Nablus, Tulkarm, Hebron and Bethlehem) indicated that while the branches operate in a fairly self-reliant manner (due to the difficulty of movement outside of the branch location), they are unable to make key decisions in a timely manner. There appears to be little flexibility or motivation to adapt products or to adapt procedures to respond to the changing political situation (closures and freezes on salaries, etc.). While branches are linked to the office in Jerusalem through a LAN internet connection and information is collected and distributed through the Loan Management Information System (LMIS), all of the client files and loan transactions are extremely manual in nature. The team did not have the opportunity to evaluate actual loan processing and reporting but it is clear that the program could benefit from a new integrated MIS system in order to reduce the current time and effort required to consolidate information at present.

### **3.2. External and Internal Constraints**

Many of these challenges are rooted in the MMD's current operating environment.

#### **3.2.1. Lack of Corporate Culture**

MMD's present status as a UN Relief Agency Department has both helped and hindered the institution's operations and growth. One of the key hindrances has been MMD's inability to cultivate the kind of corporate culture that a financial services institution needs rather than the corporate culture that a relief agency allows or requires.

This institutional attitude, or the mentality with which tasks are carried out relates to "how the reason for doing things impacts the way in which they are conducted." (2). In this sense it is clear that relief work requires that beneficiaries/refugees be seen as such, whereas a financial services institution requires that those very same refugees be seen as credit takers and savers, as financial institution clients, independent of the fact that they may or may not be refugees(3).

This fundamental difference lies at the heart of the institutional transition sought by MMD - the need to create and develop the corporate culture of a financial services institution.

#### **3.2.2. Association with UNRWA**

MMD enjoys a certain amount of comfort from its institutional home within the UN in terms of name recognition among clients, easy access to grant financing, and support in negotiating mobility for the program, such as slighter ease in passing through checkpoints, particularly for Palestinian staff working in Jerusalem. Staff at several of the branches also commented on they value of the UN ID card and the benefits it affords them. At the same time, this close connection has in some cases hindered the program's ability to collect repayments, particularly in times of crisis when the same populations may also be receiving humanitarian assistance for other UNRWA programs.

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2 Or, to put it in relational terms: the way the "why" impacts the "how".

3 A very high proportion of MMD clients are Palestinian refugees.

### 3.2.3. Need for Long-term Permanence

Microfinance's impact is a long-term proposition requiring sustained systematic use of credit for at least a decade if not for a whole generation, in order to allow the poor to build assets<sup>(4)</sup>.

Access to microfinance will impact the microentrepreneur's family almost immediately after disbursement. However, it should be the target of a microfinance institution to survive long enough to continue providing credit, and influence the lives of more microentrepreneurs. This can only happen if microfinancial services that have built long-term institutional permanence into their strategy are present in the community. Naturally, it is for this reason that long-term permanence constitutes an overriding rationale for the institutional transition of MMD. If a microfinance program does not plan for long-term permanence, it is probably better not to launch it at all. Without its long-term permanence, without access to an institution that is present in their community year in and year out over the long-term, a microcredit and savings program's clients cannot build assets and therefore cannot achieve a structural exit from poverty.

In looking toward the future, one must recognize that while UNRWA has been operating in the region for the past 16 years, it was never the intention to have UNRWA be a permanent organization. It operates based on a contract renewable every three years. The continuity and structural integrity of MMD right now depends on a perpetually postponed peace agreement. Once a peace agreement is in place, in principle, there will no longer be a need for UNRWA and the organization will be dissolved. This is a very tenable situation for a financial institution to operate within, particularly in terms of long-term strategic planning and staff security. Optimistically looking toward a peace agreement in the near future, there is a very important need to ensure the permanence of MMD in order to secure its assets, both human and capital. Transition will provide an effective exit strategy for UNRWA; one which will allow MMD to continue the important work of providing access to financial services for its current clients and those yet to be served.

### 3.2.4. Absence of Management Independence

Sustainability, and therefore long-term permanence, can only be achieved with quick responsiveness to the market. A precondition for this quick responsiveness is the possibility (and the ability) to make agile implementable business decisions based on alertness to market indicators. Herein lays a key reason for MMD's Institutional transition: its need for an unencumbered decision making powers that will allow MMD to respond effectively, and in a timely manor to the market indicators.

Whether the decision is related to opening a new branch; changing the interest rates, changing the currency with which loans are made<sup>(5)</sup>; selecting new personnel, or even creating a new corporate department; the question is not only what decisions are to be made, rather than how fast they can be

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<sup>4</sup> The most obvious and major strategy out of poverty.

<sup>5</sup> Six currencies make up and are involved in MMD's funds and portfolio currency mix. This feature alone, the alert reader can imagine, constitutes a management nightmare if it has to be done with out total independence and the freedom to take business decisions.

taken and implemented. Sustainability after all is productivity, and productivity is made up of smart, correct business-like decisions, followed by nimble implementation.

However, in its current form, MMD management is unable to make key decisions (particularly related to with recruitment, procurement, and internal training) in a judicious and timely manner because of the extensive UNRWA bureaucracy and the time needed to negotiate and comply with standard UN procedures. For example, all hiring must follow specific UNRWA guidelines, limiting the pool of potential candidates and extending the timeframe in which positions can be filled. While these constraints are inherent in large international organizations, they are not conducive for operating an agile, responsive business.

Unlike other MFIs operating in Palestine and Jordan, management has many responsibilities that are not even related to MMD's microfinance operations because it is simply part of UNRWA. It is estimated that the Director spends at least 60-70% of his time working on UNRWA issues, reducing the amount of attention that can be devoted to the activities of MMD, placing an inordinate amount of responsibility on other senior staff, and ultimately having a negative effect on MMD's performance. It is clearly not an efficient use of the Director's resources.

MMD staffs salaries are in line with other UNRWA staff (those working in the health, education and humanitarian assistance programs) but are not competitive with other MFIs. For example, loan officers are paid the same as a social worker in the UNRWA system. MMD is unable to adjust the salaries as needed to compensate staff for higher levels of experience and education or to reward staff according to their effort or to make positions more competitive. As a result, Staff turnover has been high.

Combined with the management constraints mentioned earlier, one of the most significant results of the lower staff salaries and the lack of incentives has been the lack of innovation or drive on the part of the staff to solve problems, especially those arising because of the political situations<sup>(6)</sup>. Based on field visits to various branches, staff seems to heavily rely on management to come up with solutions, while management does not have the flexibility or the proximity to help solve problems. The result is that many branches are simply struggling to recover loans and make existing loan products work the same way in an ever-changing and ever-challenging environment. Effective product adaptation is prevented by these existing constraints. Without product adaptation, MMD will have a difficult time growing and thriving.

MMD cannot serve its clients to the full extent possible under the current framework – both because of its being under the UNRWA umbrella and as an unregulated, non-deposit-taking MFI. Transitioning will enable MMD to strengthen and innovate in key ways in order to reach its long-term goals.

### **3.2.5. Lack of Legal Enforcement**

Due to the political instability, there is limited legal enforcement for defaulted loans in the West Bank and virtually no enforcement in Gaza, leaving little chance for collection or adjudication of unpaid loans. Currently there are an overwhelming number of cases before the court in the West Bank<sup>(7)</sup>. In

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6 such as restricted or closed travel due to the establishment of additional checkpoints or the lack of legal enforcement for defaults

7 As of August 2007, there were 700 cases pending in the court for the Nablus branch.

one branch, two lawyers are engaged for one hour each day to pursue defaults through the judicial system. Despite the inordinate amount of effort spent trying to collect defaulted loans, few of these loans are recovered.

### 3.2.6. Unmet Demand

In spite of the ongoing debate in the microfinance world regarding the size of the microfinance market<sup>(8)</sup>, the underlying thesis of this report is that although demand for microfinance is by no means spontaneous, high quality service can unleash literally “unlimited” demand for financial services. We already know what high quality service entails and what it can provoke. In this context, one can assume that post transition MMD can unleash demand. However, there is a little doubt regarding the immensity of the market for savings products and microfinance products. Meanwhile, it is important to note that microfinance is a volume business <sup>(9)</sup>, productivity largely and in large part, depends on the Microfinance institution’s ability to conquer its market.

Overall, MMD will need to become profitable before transitioning and will need to continue to be profitable during and after its transition. This will happen through better portfolio quality, which implies a reduction in the loan loss expense; higher productivity, tighter cost controls, continued portfolio growth and better asset utilization rates.

### 3.3. Positioning in the Microfinance Sector in Palestine

Established in 2002, the Palestinian Microfinance Network is made up of nine members (ACAD, ASALA, FATEN, PDF, PARC, ANERA, CHF, UNRWA, and YMCA) and one associate member (Caritas-Jerusalem). As of December 2006, the Network statistics indicated that all MFIs in the sector were serving 23,202.00 active clients (with UNRWA serving 40% of this total) and an outstanding portfolio of USD\$ 38,078,455.78 (with UNRWA representing 15% of the total sector).

Other areas of comparison include <sup>(10)</sup>:

ITEM	UNRWA	Total	% of Total
Loans Disbursed (cumulative)	107,568.00	211,677.00	51%
Amount Disbursed (cumulative)	113,192,145.00	250,482,814.75	45%
Cumulative # of clients served	39,043.00	142,721.00	27%
Active Clients	9,190.00	23,202.00	40%
Outstanding portfolio	5,830,805.00	38,078,455.78	15%

8 In this debate, experts’ opinions regarding the demand for microfinance range from a low of 5% of the self employed population to no more. In the most optimistic of cases, this range is perhaps as much as 15 or 20%.

9 And although it is a volume business, operation must be personalized, the institution must learn to manage a huge number of operations on a first name basis, in other words, every single loan must be collected.

10 The Palestinian Network for Small & Microfinance, Performance reflection through statistics -2006. Source: [http://www.palmfi.org/reports/Dec\\_06.xls](http://www.palmfi.org/reports/Dec_06.xls)

Cumulative # of Women Clients served	12,516.00	102,739.00	12%
Loan Officers	88.00	187.00	47%
Total Employees	183.00	357.00	51%
<b>Indicators</b>			
Average Loan Size released	1,052.28	1,183.33	89%
Average outstanding balance	634.47	1,641.17	39%
Portfolio per Credit Agent	66,259.15	203,628.11	33%
Active Clients per Credit Agent	104.43	124.07	84%
Active client per staff	50.22	64.99	77%

MMD plays a key role in the Network, with the MMD Operations Director sitting on the Board of Directors. MMD is well-respected in the Network and is recognized as the largest microfinance provider in the industry (number of clients)

Based on interviews with the Network Director, the Chair of the Board and staff of one of the Network members, the microfinance sector is characterized by a small number of small Miss, which are often competing for the same clients in a limited number of areas. Most are plagued by challenges of staff retention, low profitability and high risks. Admittedly the providers are not serving the sector as effectively as possible. One approach that had been discussed in the past was of a merger of three programs (Faten, ASALA and ACAD). The idea was to reduce competition and maximize outreach. Unfortunately the organizations were unable to agree on the details, particularly the power sharing structure of the proposed merged institution. Nonetheless, the Network believes that a merger is the best approach to succeed and to best serve the microfinance sector.

### 3.3.1. Al Rafah Bank

Licensed in 2006, Al Rafah Bank represents the first fully commercial bank to serve the SME and microfinance sector in Palestine. With an initial core group of influential business investors with a desire to receive both a financial and social return (who together committed \$12.25 million), the current leading shareholders (out of over 19,000 in total) are as follows:

- Paltel – 6.7%
- Padico – 6.7%
- Lotus Finance – 3.3%
- Birzeit for Medical Co – 3.3.%
- Gaza Investments & Development and Co – 3.3.%
- Trust Insurance Co. – 3.3%

The bank currently has USD\$ 30 million in equity including 4.3% of deposits. In terms of the outstanding loan portfolio (USD\$ 16 million), deposits represent 40% of the total amount. The portfolio is broken down into USD\$ 8 million in microfinance loans and USD\$ in corporate loans.

In terms of structure, Al Rafah has a fairly small unit run from the head office in Ramallah which serves the corporate clients. The rest of the bank is focused on developing an expertise around SME and microloans. Several months before August 2007, the average loan size was USD\$ 8,000. The bank is

now pushing to reduce loan sizes below USD\$ 4,000. The bank had opened a branch in Gaza, but it was closed at the time of the interview (August 2007). A branch is planned for Nablus by the end of the year. Al Rafah is currently exploring a partnership with PARC in order to open a “mini-branch” window in the same location as the cooperative in order to provide microentrepreneurs access to the banking system.

Following a feasibility study looking at the different options for doing business, the founders decided to apply to the Palestinian Monetary Authority for banking license. They were first told to forget the idea. However, after the PMA had reviewed their business plan, giving acceptance in principal, they received their license after one year. The founders chose the bank structure because it would allow them to offer a full range of financial services including commercial loans, Visa, SWIFT, remittances. With diversified services, the bank could achieve stability and income. The challenges the bank faced include the lack of enforcement of loan defaults (as in the case of MMD) and the political and economic instability. According to the information given during the interview with the General Manager, taxes are 29% of net profit. Reporting requirements are extensive (monthly, weekly and daily reporting) with monetary authorities visiting the bank for 3-4 weeks twice a year.

In terms of performance, the bank’s ROE is lower than other commercial banks in the country, but the founders and shareholders are comfortable with the level, according to the General Manager. The current interest rate on group microloans, 5.5 – 5.9% flat, is about ½ the interest rate of other MFIs (including MMD). A loan origination fee of .5% covers insurance (death or accident during the loan term which allow complete write-off of outstanding loan balance). The bank maintains that it will be able to maintain a profit at the current interest rates. Externally, the bank is not seen as a competitor to the MFIs operating in the country because microfinance represents such a small percentage of the bank’s assets, because of the very high minimum loan size, and because of their lack of experience in microfinance. Due to the strict operating rules of a commercial bank, Al Rafah only offers collateralized loans.

### 3.3.2. Financial Sector Development

Over the past several years, the UN has embraced and promoted an approach based on the idea that “microfinance services will, over time, become an integrated part of the financial system.” The 2005 International Year of Microcredit celebrated the achievements of microfinance to date and looked to further advance the idea of building inclusive financial sectors, which includes providing normally, excluded people financial access at a reasonable cost to a range of financial services including, savings, credit, leasing and factoring, mortgages, insurance, pensions, payments, and domestic and international money transfers.

*“The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector. Together, we can and must build inclusive financial sectors that help people improve their lives.”*

UN Secretary-General Kofi Annan, 29 December 2003,  
Following the adoption of 2005 as the International Year of Microcredit

The United Nations has supported the move towards financial sustainability of microfinance providers throughout the world particularly through the work of the UNCDF and the UNDP. One of the most

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successful early examples of the transition of microfinance NGO to a regulated, deposit-taking financial intermediary took place in Cambodia. The Association of Cambodian Local Economic Development Agencies (ACLEDA) began operations in January 1993 with the support of United Nations Development Program and the International Labor Organization, transforming into a licensed bank in October 2000. Since then, ACLEDA served more than 159,930 clients (up until Dec. 2006), compared to 60,860 in Dec. 2000.

In December 31 2001, when ACLEDA was allowed to take deposits, they were serving 3,836 savers. Today, ACLEDA handles deposits to more than 141,368 savers. Maintaining an active loan portfolio of USD\$ 158,076,146 and deposits of USD\$ 123,149,616, ACLEDA Bank now provides loans, savings, money transfers, payroll and other payment service, and cash collection its clients throughout Cambodia.

One example where UNRWA had a direct stake in creating a for-profit lending agency was in Jordan. In 1953, UNRWA, contributing USD\$ 420,000 in capital, set up an intermediary agency, the Jordan Development Bank to offer loans on a retail basis. UNRWA divested from the Bank in 1972.<sup>(11)</sup>

### 3.3.3. Political Climate

Since its inception, MMD has operated in one of the most volatile political situations in the world. While the program has tremendous potential to reach a much larger segment of the population, the success achieved to date is commendable, given the particularly challenging circumstances in which it has had to operate.

The economic and security situation has continued to deteriorate in the West Bank and Gaza, due to Israeli incursions, expansion of the separation wall/fence, the closure regime, curfews, the withholding of tax revenues, and other restrictions that have led to among other things a marked increase in poverty. The suspension of direct aid to the Palestinian Authority following the democratic election of a newly formed government under Hamas in March 2006 and the ensuing factional fighting in the Gaza Strip have contributed to a growing economic decline. There have been a number of internal attacks on UNRWA property and staff. The freezing of international funds caused almost all services provided by the Palestinian Authority to stop. This resulted in 7% percent shrinkage of the economy and a spike in unemployment of 30 percent <sup>(12)</sup>.

Further compounding the instability was the breakdown of the unity government in November 2006; established only months earlier by the Abbas led Fatah movement and Hamas' Ismail Haniyeh. In December, Mahmoud Abbas's calls for early elections triggered clashes between Fatah and Hamas. Following months of intense fighting in the West Bank and Gaza, including raids by and into Israel, interspersed by a series of ceasefires, Hamas took over the Gaza Strip from Fatah in a series of battles in June 2007. President Abbas subsequently dismissed the Palestinian government (which was ignored

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11 Annual Report of the Directors of the United Nations Relief and Works Agency for Palestine Refugees in the Near East - Covering the period 1 July 1951 to 30 June 1952 (<http://domino.un.org/unispal.NSF/f45643a78fcb719852560f6005987ad/0e598b25ff3267e20525659a00735ea7!OpenDocument>)

12 Report of the Commissioner-General of the United Nations Relief and Works Agency for Palestine Refugees in the Near East, 1 January -31 December 2006. General Assembly Official Records, Sixty-second Session, Supplement No. 13 (A/62/13).

by Prime Minister Haniyeh of Hamas) and declared a state of emergency after six days of bloody factional fighting. On June 15, Abbas appointed an independent lawmaker, Salam Fayyad, to serve as Prime Minister of the emergency government rejected by Hamas Islamists. Following the United States decision to lift a ban on aid to the new Palestinian emergency government, a new 13-member emergency cabinet was sworn in on June 14 2007<sup>(13)</sup>.

The result of this recent series of events is that, as of August 2007, two de-facto governments are ruling the West Bank and Gaza, Fatah in the West Bank and Hamas in Gaza, each concurrently exercising their political, security and economic power. The banking sector, for example, has been caught in the middle with the Fatah led government in West Bank prohibiting financial institutions from lending to Hamas members in Gaza and the Hamas-led government in Gaza threatening to close branches of banks which refuse to lend to Hamas members.

#### **3.3.4. Palestinian Financial Sector**

This stand off between Fatah and Hamas has had a direct impact on the regulatory environment in both the West Bank and Gaza, which remains in a continued state of flux. While there is a sense that eventually the impasse will be resolved, and that some stability will return, the current political climate for banks is one of difficulties they continue to face. The overall banking sector has suffered due to freezing payments of government salaries. Yet, some relief was received when the emergency Fatah-led government in the West Bank was sworn in.

Currently, there are 22 commercial banks operating in the West Bank and Gaza, including one microfinance bank, Al Rafah, which began operations in 2005. Commercial banks are regulated by the Palestinian Monetary Authority (PMA), which is now dealing with the affect of the governmental crisis. While PMA supports the idea of commercial microfinance (as evidenced by the issuing of a license to Al Rafah Bank), it is not interested in issuing new bank licenses at this time, as it does not enjoy enough staff capacity to handle additional banks given the volatile economic situation.

Therefore, there have been several recent initiatives to help encourage currently established commercial banks to explore the microfinance market. In 1998, the IFC invested in three banks in order to support small and micro enterprises in Palestine. According to the IFC, and while participating banks felt the profitability of the program, they did not continue the loans. Another initiative to support the sector includes the Palestinian Investment Fund (PIF), a USD\$ 230 million guarantee fund, backed by OPIC and CHF International, aiming to guarantee 70% of loan amounts provided to Micro enterprises.

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13 TIMELINE-Key events since 2006 Hamas election victory. Source:  
<http://www.reuters.com/article/topNews/idUSL1752364420070617?pageNumber=3>

## 4. Institutional Considerations

### 4.1. Overview of the Existing Legal/Regulatory Environment for Microfinance

Forty years of military occupation in the West Bank and Gaza (WBG) has left the economy much less developed than other countries in the region, with donor funding and remittances from the export of labor making up an increasing share of GDP. While the Palestinian Authority has taken major steps to promote a more enabling environment for private investment, efforts have been halted by the recent election, leaving major gaps and contradictions in the legislation between the West Bank and Gaza, where Jordanian law, British Mandatory laws, Egyptian administrative orders and Israeli orders have yet to be harmonized.

Up until now, this has had little impact on the microfinance industry, where the vast majority of MFIs function as Non Governmental Organizations (NGOs) operating outside of the financial system. However, as the Palestinian Monetary Authority (PMA) and the newly created Capital Markets Authority (CMA) become more aware of the potential role of microfinance in financial sector deepening and private sector development more broadly, and NGOs begin to rethink institutional options more conducive to the sustainable delivery of financial services, this will begin to change.

For example, the CMA is currently drafting guidelines for the licensing of Small and Microfinancing Entities, pursuant to Articles No. (3) and 26 of the Capital Market Authority Law No. (13) of 2004. According to these instructions, every MFI must obtain a license from the CMA to engage in the business of small and Microfinancing and must be registered as a private shareholding company (profit or not-for-profit). MFIs will not be allowed to engage in insurance or to mobilize deposits, unless fully licensed as commercial banks, and will be given a lower capital requirement than financial companies (14).

These guidelines would give regulatory authority of this class of MFIs to the CMA, which is in direct conflict with the PMA's authority to license and regulate financial companies. As such there is a current debate between the two agencies over final jurisdiction, which will likely end up with the PMA, the more established and politically powerful body.

In addition, there is a microfinance law being developed with support of the European Union that would create a new category of deposit-taking MFIs ostensibly regulated by the PMA. However, given the tremendous strain on the PMA since the recent elections and, as mentioned earlier, the current de facto two-government rule where Hamas and Fatah issue contradictory decrees daily, it is unlikely that the PMA would be interested in adding this additional supervisory function to its already overburdened responsibilities. The Director of the Banking Supervision Department made it clear to the QFI's mission team in no uncertain terms that the only way an MFI can mobilize deposits is to become a fully licensed commercial bank.

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14 The instructions for the Licensing of Small and Micro Financing Entities is currently in its draft form and available for internal circulation only.

It may be possible for an agency such as UNRWA to negotiate a Memorandum of Understanding with the PMA to make an exception to the existing legal framework, allowing it to mobilize savings that it does not intermediate. However, this type of industry development through special exemption is not recommended, as it tends to lead to market distortions and does not help the industry as a whole move forward in a safe and structured way. In addition, this type of special exception would only address one half of the savings equation for MMD – new products for clients – leaving the bigger issue of capital for financing growth unresolved.

#### 4.2. Current Institutional Options

In the absence of any final approval on either of the above-mentioned microfinance edicts, the existing legal forms available for spinning off MMD from its donor base are NGO, cooperative, private shareholder company and a commercial bank.

**a) None Governmental Organization (NGO):** The vast majority of MFIs in Palestine are registered as NGOs with the Ministry of Interior (MOL) under Law No. 1, Year 2000 concerning Charitable Associations and Community Organizations. NGO MFIs are allowed to receive funds from private and public sources to support income-generating projects, provided that revenues are used to cover the costs of its activities for the public good. The tax-exempt status that they enjoy has enabled these MFIs to keep financial costs down. However, burdensome administrative requirements unique to NGOs usually increase operational costs and create inefficiencies for the programs. Furthermore, the real limitation of the NGO model is the inability of accessing private capital through equity investments or loans. This makes it extremely difficult for NGOs to grow beyond their donor base of financing.

**b) Cooperative:** There is one MFI registered under the Palestinian Cooperative Law (No. 50), acting as a voluntary, non-governmental, member managed institution under the Ministry of Labor. This institution is allowed to mobilize member savings, but not from the public. While financial cooperatives offer a very interesting alternative for the poor to access both credit and savings services, their member based financing tends to keep their operations small and localized, limiting their potential large-scale growth.

**c) Private Shareholder Company:** Several MFIs in Palestine are registered as private shareholding companies under the prevailing companies' law. The British Mandatory Companies Law (Law No. (18) 1929) is the prevailing legal authority for companies registered to do business in Gaza, administered by the Ministry of Justice. The Jordanian Companies Law (Law No. (12) 1964) applies for the West Bank, administered by the Controller of Companies within the Ministry of Commerce and Industry. There is reciprocity between Gaza and the West Bank where companies can operate in either jurisdiction, to help address inconsistencies until a new law is enacted to unify existing arrangements.

In spite of the varying laws and supervisory bodies, the process of registering a local or a foreign company in the Palestinian Territories is very straightforward and can be done by local lawyers in a matter of days. The legal framework applicable to company registration is generally the same in both the West Bank and Gaza (15).

A financial company defined under the Banking Law is any company formed and registered for the purpose of making financial transactions for funding development projects, investments, investment management, or brokerage according to the provision of the law. Inconsistency between the Banking Law and the Capital Markets Law regarding the supervisory body for non-bank, non-deposit-taking financial institutions has resulted in disagreements between the PMA and CMA over the ultimate regulatory authority. Again, it is anticipated that the final authority will ultimately rest with the PMA.

**d) Commercial Bank:** There is one MFI in Palestine, Al Rafah, operating as a commercial bank under the Banking Law. The PMA Law clearly states that all banks and financial institutions engaged in banking activities (defined as all financial services, including the receipt of deposits; use of deposits, either whole or in part with other bank resources, for investments, loans or any other manner permitted by the law) fall under the licensing and supervision of the PMA.

All banks requesting a license should be registered as public Shareholding companies. There is a minimum capital requirement of USD\$ 30 million and a minimum capital adequacy ratio determined by the PMA. Specific regulations and guidelines are communicated through circulars directly to the banks and are not available to the public. Foreign ownership is restricted to 49%, with the investment of a single owner not to exceed 10%, 50% for founders.

### 4.3. Parameters for Change

When appraising different institutional options for MMD transformation, there are a number of key issues that will have a major impact on the final decision:

#### 4.3.1. UNRWA's Institutional Mission

MMD's has a clear vision of becoming a fully capitalized microfinance institution that can achieve regional development, economic growth, business improvement and rehabilitation, poverty alleviation and social protection. In its five year, Medium Term Plan, the management presents a plan to become a sustainable and self-sufficient MFI that is a leader in the region. MMD will continue to have a Palestinian refugee focus, but realizes that as it expands beyond its project boundaries, it will need to continue opening up its services beyond strictly refugees to include all the unbanked as part of its pro poor mission. In order for it to reach this goal, MMD has agreed that it is necessary to transform from its current project status into an independent, private, multi-service, deposit-taking, microfinance institution capable of operating on a regional basis.

#### 4.3.2. Importance of Regional Operations

The microfinance operations in the West Bank and Gaza have historically made up the bulk of MMD's portfolio. However, since the beginning of the second intifada and the opening of new branches in Jordan and Syria, that trend has begun to change as growth in these new markets is beginning to make up a larger portion of the total portfolio. Currently, West Bank and Gaza account for USD\$ 4,680,337

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or 65% of the total outstanding portfolio. Further more, and according to MMD Five-Year Plan, by the end of 2009 operations in Jordan and Syria will make up almost 50% of the existing portfolio. This regional distribution will continue to be extremely important for the new entity in the future for portfolio diversification, by helping to even out the performance of the Palestine operations. Existing regional operations and future expansion will also be an integral part of the future vision of becoming a regional microfinance bank. In addition to Jordan and Syria, there are plans to explore Lebanon and Iraq, once the situation allows.

#### **4.3.3. UNRWA's Ongoing Ownership and Governance Role**

MMD has received over USD\$ 20 million in donations since its inception. As of June 30, 2007 MMD has total assets valuing USD\$ 17.3 million. The bulk of this funding has come from USAID, OPEC Fund, AGFUND and the Governments of Australia, Canada, Italy, Japan, Norway and Germany, in the form of grants with no restrictions regarding their use beyond the contract life. It is therefore anticipated that regardless of the model selected, UNRWA will continue to have an ownership role over these funds, to ensure an ongoing commitment to the program's institutional mission and vision and safeguard the significant equity base that it has been endowed with over the years. The ultimate form the new institution takes will depend largely on the desired nature and duration of this role to be decided by the MMD Board and UNRWA legal.

#### **4.3.4. Private Sector Participation**

As MMD transforms from a project to a private, multi-service, deposit-taking institution, it will leave behind its donor base of funding and will need to begin thinking about diversifying its capital structure through a range of funding options, both debt and equity. Whatever institutional form it takes, the new entity will need to find new investors who share the program's institutional vision, mission, and aspirations to become a regulated deposit-taking MFI. During the early stages of transformation, strategic investors who share the social mission, but have a long-term vision and expertise for helping to create a locally owned microfinance institution, will be extremely important.

There is considerable interest among both local and international investors in a potential UNRWA transformation. Donors such as IFC, KfW and EIB are actively supporting the microfinance industry in Palestine and have experiences as strategic investors in newly emerging MFIs. These and other International Financial Institutions (IFIs) bring considerable investor clout and financing to the table, with significant budgets enabling large investments often with accompanying technical assistance. The downside is that they are often hugely bureaucratic and have extremely lengthy investment procedures and guidelines.

New equity funds being created for the MENA region and local private investors such as Palestinian Telecommunications Company - Paltel and the Palestinian Investment Fund present other options for private financing by socially responsible investors, willing to take more risk in order to promote economic financial sector development. These investors are generally characterized by a higher level of involvement and longer-term commitment than pure commercial investors who are simply looking for a short-term financial return. Finding investors will not be the big challenge. Finding the right investors at the right time is more the issue.

#### **4.3.5. Employee Ownership - ESOP**

As previously mentioned, one of the main challenges to MMD program have been the rigid HR policies inherent in the UN system, which have prohibited incentive schemes and more market based salary scales leaving the program less competitive than some other MFIs in the market. An Employee Share Ownership Plans (ESOP) is one way to create incentives for staff and encourage support by staff for the transition process by allowing them to participate in the ownership of the new entity. Illiquidity of shares and the uncertainty of the investment make ESOP's a risky proposition, particularly for staff accustomed to the safety of the UN Provident Fund, but if structured correctly and with staff's full knowledge of their potential risks and rewards, the current staff pension fund (currently valued at XXX) should be considered an interesting source of start up capital.

#### **4.4. Implications for Existing Models**

Given the priorities and parameters for MMD's future operations, i.e. to become an independent, regional, private, regulated, multi-service microfinance institution, there are few options available within the current legal/regulatory environment in Palestine: 1) non-governmental organization; 2) a cooperative; 3) a private shareholder company; and 3) a commercial bank. Table (3.4) summarizes all those options.

##### **4.4.1. Non-Governmental Organization**

NGOs, while very useful for attracting donor funding and creating demonstration models in the field, have severe limitations when it comes to mobilizing the needed capital to become independent financial institutions. Without a specific microfinance regulatory regime, most NGOs find it difficult to mobilize private capital and are correctly barred from mobilizing deposits from the public, leaving them highly dependent on donor funds for their existence – a very precarious position for both the institution and its clients. Furthermore, the lack of any real ownership structure could put the sizable UNRWA capital at great risk, in spite of a continued governance role. The fact that most NGOs are considering transforming into privately owned companies to deal with these and other issues is a clear indication that a move in this direction would be counter to industry developments and greater efforts to build a more inclusive financial sector in Palestine.

##### **4.4.2. Cooperative**

Cooperatives are member-based associations that build up their capital base through member savings. They are generally built from the bottom up with local community leaders driving the process often with the use of volunteer staff to keep the costs down. As such, the ownership and governance structure would not be conducive to the transfer of the existing credit portfolio that would skew the inherent incentive structure of the cooperative model.

##### **4.4.3. Private Shareholder company**

A private shareholder company would be a straightforward option for MMD program in terms of meeting licensing and compliance issues. With its current capital base, MMD would have no problem meeting the \$2 million minimum capital requirement for a financial company and could register as soon as a second shareholder is identified. While it is the case that foreign participation is generally capped at 49%, special exceptions are made for strategic investors, which UNRWA would be. There are however

two main problems with this institutional form; firstly, Palestinian financial companies are not recognized in all countries in the region, for example in Syria, which would have major implications for regional operations. Secondly and most importantly, the program would still be prohibited from mobilizing savings, a key driver for transformation.

#### **4.4.4. Commercial Bank**

In the absence of a microfinance law or separate category for specialized non-bank MFIs, the only option to become a deposit taking entity in Palestine is to become a regulated commercial bank. However, this is not something that can be achieved over night or that is without major challenges.

##### *Licensing*

Faced with the extra administrative burdens of answering to two competing authorities ( Hamas and Fatah) the PMA has its hands full with the existing banks and does not look favorably on issuing any additional licenses, even for a specialized microfinance bank. The PMA has watched the experience of Al Rafah Bank and is not convinced of the need for another microfinance bank, preferring instead the option of a merger or buying an existing bank license as a more efficient and practical use of resources.

This position is not unusual for central banking authorities in the developing world that are looking to consolidate rather than add to the existing pool of underutilized banks and should not be seen as an insurmountable obstacle. That said, there are a number of preparatory steps to bring MMD's performance up to prudential regulatory standards before the PMA will likely issue a new license.

##### *Capital Requirements*

The minimum capital requirement for a bank in Palestine is \$30 million. This capital base is intended to cushion against potential losses and decrease the bank's default probability. MMD has total assets valued at \$17.3 million at the end of June 2007 and is anticipated to reach \$20 million by the year-end. With the limitations on foreign and founding shareholdings, MMD will need to line up another \$15 million to reach the minimum requirements. This should not be too difficult to source from institutional investors at this stage, namely the International Financial Institutions such as KfW, EIB, IFC, but it will be a much greater challenge to entice individual investors with the desired profile who will likely be turned off by the financial performance of the program. Additionally, for the bank to be profitable it will need to lend roughly 5 times its capital base (a rough benchmark). This would translate into an active portfolio of \$150 million, a figure that can no realistically be made up by microloans.

##### *Shareholder Structure*

Maximum shareholding by founders of a new bank is limited to 50%, with an additional 49% cap on foreign participation. These requirements are intended to promote a balanced shareholder structure that will ensure ownership accountability and sound management. As noted above, it should not be that difficult to attract public sector investors who have a mandate for supporting financial sector development in the countries that they support and would welcome an opportunity to support MMD

transformation. However, if MMD capital is counted as foreign participation (16), UNRWA will have to give up its majority position in the new bank to make room for one or more IFIs. In addition, these public investors are ideally catalytic, and must be balanced from the beginning by local investors who can bring with them local knowledge and connections, financial sector skills and professional clout. While there has been some initial interest in MMD transformation by local Palestinian investors, the current financial performance of the program (e.g. average ROE of -14.5% and a PAR > 30 days of 56% for WBG as of December 2006) will not likely attract the types of serious strategic investors MMD will need to facilitate and support the organizational change envisaged.

*Regional Coverage*

In addition to meeting the above licensing requirements, there is still the matter of regional coverage that a Palestinian banking license will not address. As of this time, Palestinian Banks cannot operate branches outside of Palestine, since the PLA is still not considered a sovereign, stable counterpart. Discussions are underway between the PMA and the Jordanian Central Bank to negotiate an MOU between the two states, however this has not yet been formalized, and in other countries, no such dialogue has even begun. Another option would be to register as a foreign bank in a country with the best tax treatment and regulatory regime (e.g. Bahrain) and then set up bank branches in each country of operation. However, in order to do this each bank branch would be subject to the banking regulations of the host country and would therefore need to meet applicable capital requirements (i.e. \$30 million in Palestine, \$50 million in Jordan, \$30 million in Syria) far exceeding the current capital base.

**Table (3.4): Institutional SUMMARY TABLE**

	<b>Commercial Bank National</b>	<b>Financial Company</b>	<b>Commercial Bank Foreign</b>	<b>Holding Company</b>
<b>Legal Structure</b>	Public Joint Stock Co.	Private Shareholding Co.	Foreign Subsidiary of the Parent Co.	Private shareholding Co.
<b>Ownership</b>	<ul style="list-style-type: none"> <li>• Founder: 20% to 50%.</li> <li>• Individual owner: Maximum 10%.</li> <li>• Foreign: Maximum 49%.</li> </ul>	<ul style="list-style-type: none"> <li>• Minimum of two shareholders, maximum 50%</li> <li>• No maximum individual owners</li> <li>• Foreign: maximum 49%, with exceptions for strategic investors</li> </ul>	<ul style="list-style-type: none"> <li>• Founder: 20% to 50%.</li> <li>• Individual owner: Maximum 10%.</li> <li>• Foreign: Maximum 49%.</li> </ul>	Dependent on country of domicile
<b>Allowable Activities</b>	Full range of banking services	Credit, leasing, insurance, mortgage	Full range of banking services	Investments
<b>Minimum Capital Requirements</b>	US\$ 30 million	US\$ 2 million	Each branch must meet host country minimum capital: Palestine: US\$ 20 Jordan: US\$ 50 Syria: US\$ 30 Million each	N/A

16 to be confirmed through the legal due diligence

<b>Capital Adequacy Requirements</b>	8%	N/A	Each branch must meet host country minimum capital	N/A
<b>Liquidity ratios</b>	?	N/A	Each branch must meet host country minimum capital	N/A
<b>Provisioning policy</b>	10%	10%	Each branch must meet host country minimum capital	N/A
<b>Coverage</b>	West Bank & Gaza	West Bank & Gaza	Regional	Regional
<b>Relevant Law</b>	Banking Law No. 2 of 2002	Capital Market Authority Law No (13) of 2004	Banking Law No. 2 of 2002	Dependent on Country of Domicile
<b>Regulatory Body</b>	Palestinian Monetary Authority (PMA)	Overlapping responsibilities between Capital Markets Authority and PMA	Palestinian Monetary Authority (PMA)	Dependent on Country of Domicile
<b>Major Constraints</b>	<ul style="list-style-type: none"> <li>• Palestinian Banks not recognized as sovereign financial institutions outside of Palestine</li> </ul>	<ul style="list-style-type: none"> <li>• Palestinian financial companies cannot open branches in all countries in the region</li> <li>• Financial companies cannot mobilize savings</li> </ul>	<ul style="list-style-type: none"> <li>• Each branch must act according to the banking law in the host country, with capital requirements far exceeding available investment base</li> </ul>	
<b>Major Advantages</b>	<ul style="list-style-type: none"> <li>• Would allow MMD to offer full range of financial products to its clients</li> </ul>	<ul style="list-style-type: none"> <li>• Quick and easy to register, low minimum capital requirements and compliance issues</li> </ul>	<ul style="list-style-type: none"> <li>• Can operate regionally, offering full range of financial products and services</li> </ul>	<ul style="list-style-type: none"> <li>• No minimum capital requirements</li> <li>• No burdensome tax issues if registered in a domicile with applicable double taxation treaties</li> <li>• Each regional operation can be structured according to what makes sense in that country</li> </ul>

**5. Recommended Options**

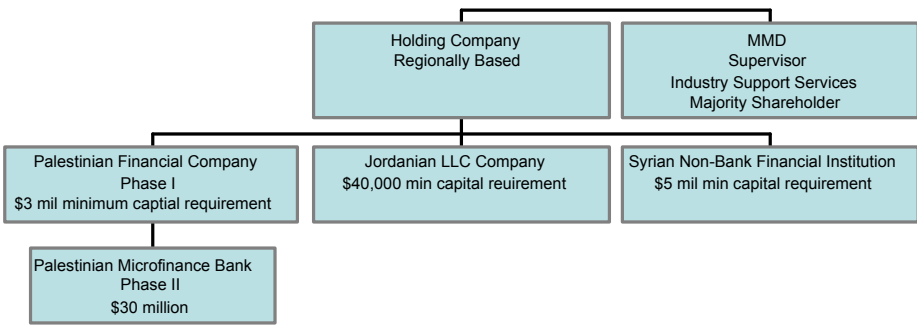
Given the current political situation in Palestine and the operational and financial challenges to obtaining a commercial bank license in the short term, the QFI mission team proposes a phased approach to address MMD’s institutional objectives to:

1. Improve quality and efficiency of services;
2. Achieve long term permanence
3. Gain management independence;
4. Better serve the market through national and regional expansion
5. Attract the private investors necessary ultimately necessary to register as a fully licensed commercial bank.

Both options satisfy the following parameters for change: (a) to Maintain the institutional vision and mission of the MMD, (b) to Allow UNRWA a say on the use of funds and (c) to maintain continuity of the program and its main stakeholders (beneficiaries, staff). The ultimate choice will depend on the UNRWA’s desired role and level ongoing involvement with the program in the long term.

**5.1. Option 1: Finance Company Model**

Register the West Bank and Gaza operations as a private non-deposit-taking financial company under the prevailing companies’ law to provide an independent legal house for the microfinance program. The minimum capital requirements are low and restrictions on foreign shareholding can be waived to maintain a majority position for UNRWA. This institutional independence would give the MMD management independence to implement some of the operational changes needed to increase efficiency and productivity and improve overall profitability necessary to attract the desired strategic investors. At the same time management can begin assessing compliance issues, licensing requirements, and establishing a funding strategy while it lines up strategic investors to help negotiate the banking license.



***Roles***

UNRWA would be the majority shareholder in the new entity, having transferred its existing portfolio in return for equity and possibly debt; and could leverage its new platform to attract strategic investors for local equity participation. The program would operate independently under the new structure with UNRWA playing a direct governance role. Ultimately UNRWA would seek a structured exit through the gradual sale of its shares to public and private investors

The MMD would be preserved as a management hub during the transition period while preparatory actions are undertaken and national microfinance programs make the legal change to privately owned microfinance companies (e.g. bank, non-bank MFI or finance company) in each of the countries of operation. Once new private share companies have been established in each country of operation, the MMD would become more of a support unit shifting its focus to providing services the newly created MFIs and developing non-financial lines of business for the sector as a whole that are more risky and costly to undertake.

### ***Ownership***

The national entities would be unified under a regionally registered holding company in a tax-exempt domicile that would invest in the creation of national microfinance entities (either wholly owned subsidiaries or as a majority shareholder) according to the legal/regulatory environments in each country of operation. This would allow UNRWA to maintain its ownership control and to preserve a common vision and shared operating systems across its regional programs selecting the institutional option that makes the most sense in each country.

Potential Shareholders:

- (a) UNRWA as a majority shareholder
- (b) Management and Employees
- (c) Private investors

### ***Advantages***

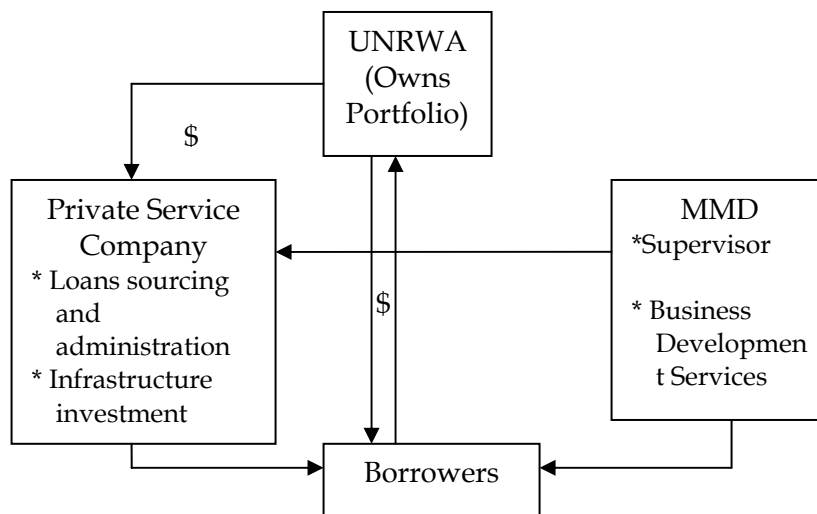
1. MMD can begin the transition process quickly and would have no problems meeting the minimum capital requirements;
2. The finance company can absorb the majority (if not the totality) of the loan officers currently employed by the MMD
3. UNRWA can maintain a majority control ensuring continuity of institutional mission as well as future progress in the transition process;
4. UNRWA can use its platform as a majority shareholder to mobilize new investors and lobby the PMA for a banking license;
5. UNRWA will have a built in exit strategy, in the event that UNRWA is dissolved, to gradually sell its shares to strategic and financial investors without disrupting operations;

### ***Challenges***

1. While there is a precedent for UNRWA investing equity in a private institution, before conducting a legal due diligence the full legal and administrative implications are not fully known and may be substantially more than anticipated;
2. Local private investors may be seriously averse to the UNRWA majority position, fearful of how they will act as an investor and their lack of power to act accordingly should investment decisions deviate from sound business practices;
3. The change in the legal status of the funds will require a valuation of the portfolio, which is a lengthy and rather painful exercise;
4. There may also be serious tax implications with regard to the portfolio transfer and certainly on the treatment of post transition profits.

## 5.2. Option 2: Service Company Model

Register the current Palestinian operations as a private shareholding service company (PSC) under the relevant jurisdictions. This would involve transferring to the new entity existing staff and infrastructure. However, the actual portfolio would stay with UNRWA and would be serviced (i.e. micro loan sourcing, administration and collection) by the new company on UNRWA’s behalf. UNRWA would remain the lender on record and would retain ultimate control over the portfolio.



### *Roles:*

As the owner of the funds, UNRWA can continue to raise donor funds and attract IFI guarantees to finance growth. It can negotiate a risk sharing arrangement with the new company who will be remunerated for its efforts according to market-based cost of capital and the associated risks.

The Private Service Company (PSC) will identify the borrowers, develop the outreach program and the products, adopt a credit methodology to be approved by the lender (UNRWA), maintain all the loan documentation, process, disburse and collect loans and monitor the portfolio according to pre-agreed upon criteria.

The MMD would play a supervisory role, setting the objectives and benchmarks, approving the lending methodology and criteria and approving the loans (at least initially). In addition, the MMD could provide Business Development Services (BDS) directly to the borrowers, in coordination with the PSC and to support the borrowers’ businesses.

### *Ownership*

The regional service companies can be established as a collection of shareholding companies in the various jurisdictions (even one each for Gaza and the West-Bank). There is no minimum capital

requirement as the PSC is not the lender, just a service provider to the lender. The capital requirements will be determined by the infrastructure investment associated with providing the service (branches, MIS, staff, working capital, etc.). This will also depend on the new PSC buying or leasing the current UNRWA/MMD premises and the new ones to be envisaged.

Potential shareholders of the new service companies:

- (d) Management and Employees
- (e) Private investors
- (f) UNRWA if needed and provided it keeps a minority position (less than 10%).

The collection of service companies can be integrated under one holding or larger corporation established anywhere.

### ***Potential Advantages***

1. MMD can begin the transition process quickly and would have no problems meeting the minimum capital requirements in each country of operation;
2. Would require minimum start up capital to cover existing infrastructure, staff and working capital, which can take the form of UNRWA's equity stake and staff ownership participation;
3. The PSC can absorb the majority (if not the totality) of the loan officers currently employed by the MMD;
4. UNRWA's ongoing ownership of the capital would allow it continue using its tax-exempt position to raise donor funds and attract IFI guarantees to finance growth;
5. Through its loan officers, the PSC could – on behalf of full financial institutions- sell other microfinance products, such as savings, insurances, remittance services, etc.;
6. The PSC would be remunerated according to its performance;
7. UNRWA's funding could be directed towards the portfolio, i.e. the risky part, not into bricks and mortar (branches and MIS). It will at least enjoy a minimal leveraging;
8. UNRWA can eventually exit through (a) securitizing its portfolio (i.e. packaging it and selling it to investors), (b) transferring the portfolio once the regulation will allow the creation of a microfinance bank.

### ***Challenges***

1. Staff transferred to the PSC must have similar or better terms than they currently have – This is normally the case as their remuneration will have an upside linked to their performance;
2. May be psychologically more difficult for staff to accept that UNRWA does not have a continued ownership role in the new company – that UNRWA will be their client rather than boss;
3. Will require the reinforcement of MMD's supervisory function – training will be necessary to set standards, to monitor and to take corrective measures.

## **6. Transition Process: Next Steps**

Once legal and financial feasibility for the institutional transition proposed has been established within UNRWA, and key partners and Directors have given the go ahead, the process of carrying out the institutional transition can begin. The transformation process should be seen as a series of stages that each deal with a specific set of short, medium and long-term goals.

### **6.1. Pre-Conditions for Transition (Short-term – 12 months)**

Most microfinance institutions contemplate and carry out transition from a not-for-profit to a commercial company because their pre-transition status, whatever that may be, poses great limitations to their access to funds for on lending and therefore, on growth and market penetration. This is not the case for MMD: the program has access, in possession of sufficient funds (which in some cases have very low or zero cost), and it even has practically unlimited access to donated resources (albeit these are highly conditioned).

As this report has previously argued, MMD institutional transition is not a question of access to resources, it is a question of an ambivalent legal status and the need to assure long-term permanence, a question of management independence for improved services, and of being able to take full advantage of its potential market and, it is a question of better use of resources. In short, it is a question of enhanced productivity. Yet in order to carry out this transition, particularly to attract investors (17), the institution must show improved portfolio performance, something that its present operating conditions make very difficult and what is at the root of the transition being proposed.

While over the years MMD has managed to be moderately productive, (indeed, structurally, today its operations are sustainable), it is far from showing the profitability that is usually required of pre-transition institutions. Clearly, the argument can be made that its poor portfolio productivity is due to the enormous management and operational limitations imposed by its present status as a UN Relief Agency Department. Even so, in order for the transition process to get underway, a consistent tendency towards improved portfolio productivity over the three-year process that the transition will take will go a long way towards facilitating that process.

#### **6.1.1. Increased Portfolio Productivity**

A more productive portfolio simply means that for each new dollar of active portfolio one gets a higher return than for the previous dollar of active portfolio. When making the transition to an independent share company, a new challenge will arise for MMD: the need to make capital as productive as possible and therefore be in a position to pay solid dividends. For MMD, showing clearly that this will happen, is not just an operational necessity, it is also a strategic imperative. The better the expected dividends to be paid by the newly formed institution, the more readily funds will be available to flow in the direction of its clients.

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17 Even though it has sufficient funds, transition and the resulting long-term permanence and market penetration would require a constant inflow of resources over the long-term.

It has been proven repeatedly that the only way to reduce the cost of money, while at the same time making it available in the quantities that this market will require over the long-term, is to make the returns as attractive as possible. Clearly then, the existing MMD and the new financial institution, once it is created, have to make portfolio productivity their number one priority.

As was mentioned, this task poses a riddle for MMD. On one hand, it has extremely reduced management independence, which in return, limited their chances to improving portfolio (or operational) productivity. On the other hand, and in order to assure a smooth Transition process into an independent, private, shareholding, fully regulated company that can mobilize savings, it must make important advances in portfolio productivity.

Nevertheless, all efforts must be made, in spite of the existing limitations, to improve portfolio productivity. To this end, it is recommended that MMD begin a process of:

- Making all possible adjustments to credit delivery in the realm of:
  - a. Procedures (the steps that are taken mainly in field work including staff routine);
  - b. Operating logistics and organization (the movement of people, clients and staff required for operations, the organization of the branch routines, teller work, cash management, repayment routines and dates);
  - c. Collection techniques;
  - d. Adjustments to products, (perhaps phasing out some of the less productive ones and introducing new ones).
  
- All these adjustments would be:
  - a. On going,
  - b. Precise;
  - c. Driven by staff suggestions;
  - d. Involving no changes in policies specially UNRWA policies and
  - e. With the sole purpose of improving productivity.

## 6.2. Preparatory Stage (Medium-term – 12 months)

As MMD begins to make improvements toward greater productivity and efficiency (through staff training, product development, new MIS etc.) it can also start to plan for the longer-term goal of institutional change. This process will involve a series of activities that will lay the groundwork for the transition. They consist of conceptualizing and visualizing the post-transition institution, and strategizing and planning the process to get there. It is a problem solving stage based on design. The Preparatory Stage proposed here for MMD's transition would result in three basic **tools**:

1. **Conceptual Framework** – the fruit of a vision exercise. It helps to understand what the post transition institution will be like, and above all how it will operate.
2. **Transition Plan** – will define the process to get there.

### 3. **Business Plan** (18) – will initially describe how the first five years will play out

#### 6.2.1. **Conceptual Framework for the Preparatory Stage**

Today, MMD transition and post-transition are a set of loose ideas. In order to understand how the new financial institution will work (and therefore why the transition is being proposed) these have to be turned into a conceptual framework.

The institutional transition will require abandoning the existing operating system and adopting a new one. This new system will have new definitions, new operating principles and a new logic. As the actual transition begins, the conceptual framework will help answer the question: how do you know it will work (19)? Developing a conceptual framework will allow staff and management to understand just what is it that will change and what will remain the same and why.

Some of the substantial issues that a conceptual framework clarifies are the following:

- ✚ Articulating new vision and reaffirming mission.
- ✚ Defining the new company.
- ✚ Defining transition and reasons for undertaking this process.
- ✚ Setting new corporate culture:
  - ❖ Share company with staff participation.
  - ❖ Shifting from relief to business thinking.
  - ❖ Balancing commercial with social goals.
  - ❖ Moving from donor and credit led to demand and savings driven services.
  - ❖ Identifying and developing new partnerships.
  - ❖ Identifying new business opportunities.

By showing staff just exactly how it is that a sustainable microfinance strategy helps or allows them to fulfill their social mission, this new conceptual framework will go a long way to channel staff commitment to the post-transition MMD. In addition, by allowing them to articulate in a participatory manner and in the clearest terms possible, the project, and eventually the new sustainable microfinance mission and vision, will allow them to take ownership of the institution and thus feel that they have a greater stake in the results they achieve. Just as importantly, this will allow them to understand the link between improved operations and how transition will make the program more efficient for the client and the institution.

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18 In the case of the business plan, although it will also describe the institution as it takes shape several years into the transition, it will also be used to generate outside interest in investing in the transition process and the new institution it self, likewise, it will also be used to acquire the licensing needed to complete the transition.

19 One can rest assured that as the transition idea begins to be transmitted outside the institution and into the world of business government licensing and others the question will come up time and again. The answer has to be satisfactory and one way to assure that it is to base it on a clearly defined conceptual framework.

### 6.2.2. Transition Plan

Transition is a complex process. It requires unwavering vision, tempered by patience, strong administration, and management of strategy for getting there.

A transition plan is composed of a set of operating principles, and a set of techniques that apply those principles, together they constitute a guide for “the way things are to be done”. In this respect, a transition plan is a tool that helps carry out the transition process. A process such as transition, given all the activities involved and all the tasks that have to be carried out, needs a common thread, or in other words, an underlying basis. This is not just for the sake of efficiency. An underlying thread does not only help the management by providing a guide on which to fall back when it is not clear how to proceed, it also allows the participants of the process to understand the process itself, because it is composed of a set of principles, and/or methods.

Based on the transition plan, participants of the process learn what to expect, give continuity to the process, and take away the element of surprise about how things are to be done. The process becomes predictable and thus much more manageable for those that are part of it.

Key Elements of the Transition Plan should include but are not limited to:

- ✚ **Legal Due Diligence** – Ideally the model proposed by the mission will allow MMD to transform the current UNRWA project into a privately owned share company with regional operations structured according to the laws and regulations in each country. However, as with any institutional transition, there are a myriad of issues that will need to be considered before the final institutional format is chosen and legal entities set up.

As MMD moves forward, one of the first priorities will be to undertake a full legal due diligence to review all of the legal aspects of this proposal, both in Palestine as well as in Syria and Jordan, and assess the feasibility and obstacles, if any, to move forward. Given MMD’s current legal status, particular attention should be paid to:

- ❖ UNRWA’s ability/mandate to act as a majority shareholder in a private company (i.e. holding company, financial company, bank);
- ❖ Pre-existing contractual obligations regarding MMD’s current capital base (e.g. grant agreements, pledge agreements, agency agreements, etc.); and
- ❖ Existing employee contracts and pension obligations.

Other issues to be researched include:

- ❖ Regional holding company requirements;
- ❖ National financial company requirements;
- ❖ Relevant tax laws and implications for both the holding and Palestinian financial company; and
- ❖ Relevant labor laws.

- ✚ **Business Planning** – While the transition plan takes into account everything the MFI needs to consider to become a financial intermediary, and lays out the additional activities that need to take place to develop the capacity of the NGO to be a licensed deposit-taker, the business plan focuses on ongoing operations, plans for the future, and projected results. Therefore, updating MMD’s

five-year plan to reflect the new institutional form, product offering, capital structure, etc. will be necessary. See next page for a further discussion on the business plan.

- ✚ **HR Needs Assessment and Capacity Building Plan** - In house and on the job training will become increasingly important to prepare staff for changes that will come with the transition, both at an operations and management level. New skills will be necessary as staff shift their thinking from the development relief orientation inherent in the UNRWA superstructure to a more business-oriented approach, with a focus on establishing a clear competitive advantage in the market. Training will be needed at all levels from field staff to back office staff and management. As such, management should undertake an HR needs assessment to identify key capability gaps and a plan to address them through internal and external training opportunities. More importantly, management should be given the latitude to follow through on the plan with the use of its own discretionary funds.
- ✚ **Customer Service and Operations Review** - While there are certain administrative and institutional constraints stemming from the UNRWA relationship, which weigh down the program and add to the challenges of reaching financial sustainability, it is possible to look for areas where the performance of the current operations can be improved at the field level, in spite of the challenging operating environment. A market survey that looks at service delivery issues, competitiveness, market positioning, client satisfaction as well as the demand for new products, would give the MMD management valuable knowledge for improving customer service and developing new products, especially on the savings front.
- ✚ **Funding Strategies** – One of the primary drivers for many MFIs to transition. This category will include the growing menu of options available for the new institution including savings, commercial borrowings, and in some cases the ability to approach the capital markets with such mechanisms as private placements. MMD will need to determine the ideal capital structure of the finance company -and eventually the bank-, as well as desired alliances with strategic investors that can help facilitating the transition process.
- ✚ **Ownership and Governance Planning** – As MMD moves away from being a grant dependent donor agency to a private shareholding company, the management and its board will need to give considerable thought to the types of investors the institution will want to attract. This should include deciding what role the remaining MMD or RMMD (R&D Division) will play in the new institution, governance structure, and the expertise that the institution will want to attract into the new entity.


In addition to mapping out the key activities to be undertaken, the Transition Plan should include the steps and requisite budget that compose each activity. Furthermore, it should establish the period for each step, activity and action, and the person or persons responsible for carrying them out. Transition, like any other project has to be managed. A transition plan is the primary change management tool. As is the case with all strategic plans, it allows management, in this case transition management a clear “to do” list. It allows delegation of activities. It allows follow up on activities, and lends itself to regular updates.

Additional elements for developing an effective Transition Plan include:

- ✚ **Importance of Staff Buy-In** - As the idea of transitioning MMD from an UNRWA Department to a private shareholding microfinance institution gains strength, or rather for it to gain strength

and thus eventually become a reality, the task at hand is to work toward full staff-buy-in of the project. Staff-buy-in consists of a process through which, as the staff gain information regarding the transition, they will weigh the arguments, and accept to the transition ideas that make most sense to them. Once staff sees that these ideas work, they will validate them and adopt them, i.e., make them their own, and eventually turning them into operating habits and standing by them. This process of staff appropriation of the ideas that make up institutional transition will mean all staff will become committed to making the transition. Thus, rather than disintegrating the team, the transition becomes a *cause célèbre* around which the team rallies, one that brings the team closer together and consolidates them.

The expected results of this process are that, when time comes for the actual transition, no loans will be lost. The institution will be able to better respond to the clients and will have developed a strengthened corporate culture. It is therefore of great importance that staff buy-in to the preparatory stage of the transition. A highly participatory process in the design of the conceptual framework, the transition plan, and the business plan, will go a long way towards assuring staff that the idea of transitioning MMD into a commercial deposit-taking institution is a win-win process.

 **Participatory Workshop Series** - One of the best ways for the staff (20) to participate in the process of Institutional transition is to carry out a series of workshops where transition issues are dealt with and where everyone is invited, (indeed instructed) to come. Naturally, these workshops produce the best results when handled by an expert facilitator; even so, it is recommended that they be very participatory (21). Such a format allows for thinking to take place collectively and for everyone to listen, think through, debate and come to conclusions regarding the transition as a group.

It is probably the case that this series is composed of two or three workshops in the course of a few months. The first one should deal eminently with the subjects that are related to the conceptual framework, and answers the basic questions of the whole transition process. While the second workshop helps to produce the contents of the strategic plan and plan of action, the third one can be used to summarize the whole process and touch on some of the contents of the business plan. The time lag will allow staff to think through what is being proposed. Naturally, there will be some overlap and repetition between one and another of the series, but assuming a very professional facilitator they should produce enough material: the key decisions and the key definitions of the transition process itself as well of the post transition institution to sufficiently feed the instruments that they are meant to do so.

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20 Management will have to decide who participates and what format is utilized during these workshops. The recommendation implies that every one in the institution's payroll participate, this is ideal, but of course it might prove impractical in which case some trade offs will have to be weighed. In addition some of the experts that are going to be producing the actual instruments that these workshops are meant to provide the content for, should also be present.

21 Many MFI that are contemplating Institutional transition hire an expert consultant who carries out the preparation of instruments needed for transition in the distance of his or her office: staff are presented with a *fait accompli* that even if they read, will make little sense to them. In this transition methodology, the transition is a distant project of the Boardroom and future investors with the resulting huge staff rotation soon after transition; loss of important part of the portfolio and sometimes general disarray.

- ✚ **Working Groups** - Inevitably, some issues will not be resolved during the course of a particular workshop. One option is to name working groups that are given the task of providing the institution with a solution to a controversy in the next event of the series. This way staff is confronted with the necessity to talk among themselves about the institutional transition.
  
- ✚ **Consensus Building** - Consensus building consists of creating a large support base for the implementation of a project. It involves forming a large, broad based alliance where all those involved in the Project are encouraged to feel that they are part of it and that they have a stake in their successful completion. As a strategy for implementation, it is very time consuming and laborious, but it produces unbeatable results (22), of course it has to do with making the initiative exiting, a momentous event in development and poverty reduction in the Palestinian economy. Consensus building involves turning the different parties: MMD donors, UNRWA, staff, clients, microfinance support institutions (23), networks, and even licensing authorities, into transition stakeholders. It is based on developing solid arguments and thus showing how this is a win-win situation for all those involved and of course it precludes going at it alone or in spite of some opposition to the initiative. It is a marketing approach to the project. Ultimately, it involves generating enthusiasm among all those concerned.

While in the short-term, this is a much more complex and time-consuming way of carrying out transition, it assures success. Once broad based consensus is built, no one dares nor wants to oppose the project. Naturally, as a strategy, it requires impeccable management / marketing skills and well-prepared arguments; in the end however, a strategy of carrying out the transition on the basis of consensus is enormously more efficient. It is based on constant contact and a frank and unabashed request for support; it is based on alliance building and a high level of maintenance of that alliance.

- ✚ **Transparency of Information** - Likewise, a transition plan based on consensus requires transparency and fluidity of information. As the transition process begins, an enormous amount of information begins to become available. Information about the transition processes itself, and about the different alternative courses of action that can be adopted for accomplishing each step of the way. A consensus strategy requires management of the information: constant updates to all the stakeholders on the relevant events of the transition as they unfold and a transparent use of that information.

Although investing in, developing and completing these instruments (depending on how they are developed) moves the institution a long way towards the transition, but they are not the transition. One can say that being in possession of these instruments signals the completion of the Preparatory stage of the transition process, adopting and utilizing them constitutes the beginning of the Operational Stage of the institutional transition process.

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22 There have been MFI Transitions in which in the final stretch even the authorities that were supposed to issue the license had been made to feel that a successful outcome was in their best interest.

23 especially those that are involved in the commercial approach to microfinance

### 6.2.3. Business Plan

A Business Plan meant to depict the Institutional Transition of an MFI is not very different from a standard Business Plan that depicts the expansion stage of one such Institution.

In other words, the core of an expansion stage, MFI Business Plan mainly details an aggressive expansion of operations, which is usually what happens to MFIs that finally have capital and relatively quick access to new sources of funds for on lending.

It is safe to assume that MMD will be no different. After a prolonged period of preparation for transition that includes improving portfolio productivity, after the adjustments are made to the back office in preparation for Transition, and after its capital becomes available, Transition-day MMD will in all probability embark in an aggressive and sustained period of portfolio growth.

This pattern reproduces itself in all Transition MFIs, not only for the reasons listed above, but also because now it has to make its new capital productive quickly. It is also safe to assume that this capital will be in amounts previously unheard of at pre-transition MMD. For this reason as well, the Business Plan projections will show a noticeable change in the rate of portfolio and client growth. Thus, this will be the core feature of the Business Plan that will be elaborated for post Transition MMD. Aside from this, there are other emphases in the Business Plan that are unique and worth pointing out; the main ones are the following:

To begin with, naturally, one such Business Plan has a special section dedicated to describing the Transition process itself. The author(s) <sup>(24)</sup> of the Business Plan can gather sufficient information and data about it from the Conceptual Framework and from the other documents that the Institution has prepared during the Pre Operational Stage of the Transition. Indeed, some of these documents can even be attached as Annexes to the Business Plan depending on their quality and depending on MMD's eventual policy on making such internal documents public.

Naturally, the main purpose of this section of the Business Plan would be to argue logically, thoroughly and forcefully, the Transition itself, because even though today this strategy is being adopted with increasing regularity by MFIs that want to achieve a substantial upgrade of corporate identity and of operations, it is still a highly controversial strategy <sup>(25)</sup>.

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24 Needless to say, the best way for MMD to arrive at a high quality Business Plan is to hire a specialist in the production of one such document. It is a pretty standard task and there are many qualified and it should not require an immense level of effort especially if the documents that the person will rely on: the Conceptual Framework, existing correspondence regarding MMD's Transition, relevant minutes of the Board of Directors, the Transition Plan, and others are of high quality and are well organized.

25 The controversy and on-going debate regarding Transition is related to the larger and even more controversial issue that confronts those that believe in the commercial nature of micro finance *vs.* those claiming that this cancels off its social mission.

For this reason, it is important that the author(s) make the case for Transition clearly and unequivocally. No doubt, this section of the Business Plan should also probably go into detail about previous and recent MFI institutional transitions (26).

In addition, there is a second feature of the Transition Business Plan that makes it unique.

Since clearly one of the main objectives of the Business Plan is to help mobilize capital for the post Transition Institution, it is thus important to also pay special attention in the contents of the Business Plan with regard to:

- ✚ The sensibilities that capital and potential investors may have to finance in general, as well as to the issues of profitability, interest rates, financial returns in particular, as they play out in the Middle East; as well as,
- ✚ The returns (and therefore the operational and financial projections) that the Institution will offer over the long term.

This aspect of the Business Plan depends largely on the Conceptual Framework and the Transition Plan that MMD draws up in the Preparatory Stage of the Transition (27), at which time the Institution will have to design a policy regarding how it will balance its social mission and its returns on assets and capital.

### **6.3. Operational Stage (Long-term - 3 years)**

At this stage, the institution has already developed the ideas and arguments that make the transition irrefutable. The staff shares a common vision of what the post MMD will look like and are committed to that vision. They also have an understanding of what the transition process will entail. The three tools are either already prepared, or in the process of being written, and there is ample consultation between the staff and those in charge of producing the instruments. Efficiency gains have been made through very active participation of the staff, which is in turn generating enthusiasm for the whole transition proposition. Above all, there is a lively debate going on among staff and executives on the issues that have been raised during the workshops and in the every day routine of improving productivity. One can say that the concept of transition is alive in the institution.

Once this change has taken place, the management can move into the final Operational Stage of transition, which is composed of the following actions:

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26 There have been close to 100 Transitions to date the world over of NGOs, MF programs, projects and other type of initiatives into commercial share deposit taking MFIs. There is ample literature to document this growing trend in the MF Industry; the Business Plan in question should not shy away from detailing these experiences.

27 Clearly, if the Conceptual Framework prioritizes the social mission of the Institution with out balancing it appropriately with returns to capital, this preference will also be evident in the Business Plan and will thus probably signify that mobilization of capital more focused on social investors and therefore requiring a funding strategy aimed at reputational returns rather than financial returns.

### **6.3.1. Complying with Relevant Regulations**

Once the legal due diligence has been conducted, MMD should have a clear understanding of the steps needed to be taken to comply with the regulations that apply to register the holding company and the bank.

### **6.3.2. Savings Product Development**

A helpful timeline for sequencing the introduction of public savings comes from Marguerite Robinson in Chapter 15 of the Transformation Book (28).

1. Assess internal capabilities, identify gaps, recruit new staff as required, and retain outside experts as necessary
2. Conduct research on demand among potential savers of different kinds, and on the supply of savings facilities among competitors
3. Plan the pilot project, and design and price products and services for the pilot
4. Is the necessary institutional capacity in place to open savings facilities for the public? Create a checklist and make sure that the tasks are completed before introducing savings to the public.
5. Develop criteria for a pilot project site and select the pilot branch
6. Prepare for the first pilot project—a complex and multi-faceted task
7. Conduct the first pilot project, ensuring that adequate resources are available (and used) for the pilot and for its close supervision and regular monitoring
8. Assess pilot results and revise products, pricing, operations, MIS, etc. as necessary. If a second pilot is needed (very likely), begin the planning and preparations for step 9.
9. Plan the second pilot, selecting branches located in different environments, and train managers and staff of the pilot branches
10. Implement and evaluate the second pilot
11. Train the trainers of the trainers in preparation for the rollout phase
12. Expand gradually to all branches, training managers and staff in each location. Do not rush this step!
13. To penetrate the market, develop a detailed, systematic approach to identifying potential savers and mobilizing their savings
14. Select a pilot area, train managers and staff, and conduct a pilot in market penetration. Evaluate results, revise methods, and gradually roll out to all the MFI's branches
15. Develop appropriate strategies for investing excess liquidity

### **6.3.3. Raising Capital**

Raising capital will likely be one of the most important activities undertaken during the Operational Stage. It will require the concerted efforts of the entire transition team (see Appendix One). Selecting the right investors will not only require a close analysis of the financial resources of a potential investor

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28 Ledgerwood, Joanna and Victoria White, “Transforming Microfinance Institutions: Providing Full Financial Services to the Poor”; World Bank and MicroFinance Network. Washington, DC 2006.

(current and future) but it will also require a clear understanding of the motivation and objectives of the institution. It is very important that the potential investors share MMD’s ultimate vision and mission.

#### 6.3.4. Creating Key New Departments

As a regulated commercial deposit-taking institution, MMD will need to create a number of new departments to house the additional financial management requirements and to manage the expanded organization, which now is regulated and supervised. Some of these departments include a Treasury Department to manage the tasks mentioned under financial management. An Asset Liability Committee (ALCO) at the management and board level will need to be created to provide oversight and make decisions regarding funding. The function of an MIS Department will take on a whole range of additional reporting functions. A Legal Department will also need to be created. MMD will certainly need to create a Human Resources Department to manage all the staffing needs of the new institution.

#### 6.3.5. Licensing

With the information collected during the legal due diligence, MMD will understand how and when it will need to apply for and receive the appropriate licensing to be established as a regulated commercial deposit-taking institution.

#### 6.3.6. Financial Management

The financial management function will likely see the most changes, as it is responsible for how the institution manage its cash. The Chief Finance Officer of the new institution will need to oversee a number of new functions including asset-liability management, capital adequacy ratios, tax accounting, capital budgeting and forecasting, investor relations, and monitoring the spread between deposit-taking and lending operations.

**Summary Matrix of Main Recommended Institutional Transition Tasks**

Task	Brief Description	Main purpose	Timing and Duration	Expected Results
<b>Pre Operational Stage Tasks</b>				
<b>Elaboration of Conceptual Framework.</b>	In a very participatory type of setting, the main internal stakeholders: Directors, Management and Staff, fashion a Vision of the post- Transition Institution.	Define the future in as concrete terms as possible.	Once Transition has been officially decided upon  Workshop, 2 or 3 days to iron out a Conceptual Framework.  Document elaboration 2-3 weeks.	Shared view of the Post Transition Institution.  Appropriation by staff of Transition Process and of the future Institution that it will produce.  Clear arguments: raison d’être, mission and other key ideas for the Transition process.
<b>Implementation of Pre-Conditions for Transition.</b>	Piece meal improvements on the existing credit delivery system specially on:  -Product features,	Make portfolio more productive.	ASAP until high levels of productivity and efficiency have been attained.	Institution is profitable.  Greater interest from potential investors.  Raising capital becomes a

	-commercial strategy, -logistics, -credit procedures, -organization of tasks.			simpler task.  Improved morale.
<b>Elaboration of Strategic Plan</b>	Highly technical and structured series of working sessions with one final all- staff workshop.	Specifies the method, (principles, ways, techniques), with which the Transition Process will carry out its objective.	Two or three month process culminating in a 2 or 3 day all-staff workshop.	The Transition process, specifically the Operating Plan has underlying techniques and methods; therefore it is much easier to elaborate and thus to carry out.
<b>Pre Operational Stage Tasks (continued).</b>				
<b>Elaboration of Operating Plan or Plan of Action</b>	It contains a detail of the tasks, actions down to the steps and activities that will be taken in order for Transition to take place. It includes those responsible for each of the tasks as well as a chronology of when each task will be carried out and completed.	The Plan assures a smooth Operating Stage of the Transition process.	Two month process culminating in a 2 or three day workshop.	The Transition is an organized activity.  Fewer things go wrong in the Transition Process.  There is a Plan B for all major tasks.  Potential for failure is highly reduced.  Little time is wasted on redoing Transition tasks.
<b>Elaboration of the Business Plan</b>	An all encompassing document written by a specialist that gathers and synthesizes all the important points of the materials previously mentioned, specially those that apply to outside consumption.	Raise capital.  Apply for Regulated Institution License.	Sometimes this is considered the last of the Pre Operational stage Tasks, and in some cases it is considered the first operational stage task. An expert will require from two to three months of intensive full time dedication.	Public at large but specially targeted outsiders can become fully informed of the Transition process.  Post Transition MMD has financial and operational Projections.
<b>Implementation of the Operating Plan or Plan of Action</b>	The above document (Operating Plan), is put into action, this is the core of the Transition Operational Period. Tasks are carried out on the basis of the Plan.	Raising Capital  Applying for Operating license.	Implementation begins the day Action Plan is approved by Directors. Lasts about 2 years.	MMD successful transitions to becoming an independent, private share capital, regulated multi service micro finance institution to which it transfers all or most of its assets, liabilities staff and operating technology.

## **Appendix One: Transition Team Terms of Reference**

Because of the significant scope of work involved in the transition process, it is recommended that a team be engaged to work with MMD to help guide them through the process. This will allow management to focus their attention on the day-to-day activities of the core business and on executing the strategies necessary for expansion and growth into a more financially viable company. Additionally, several aspects of transition will require specialized expertise. The primary role of the **Transition Steering Committee** will be to provide oversight of the transition process and to approve the outsourcing of technical and legal assistance. A **Senior External Transition Advisor** will provide outside guidance to inform the process and will engage and draw in the right kind of strategic partners and investors. A full-time, on-site **Transition Adviser/Specialist** will be responsible for managing the overall transition process including overseeing the reengineering of the business process.

### **Transition Steering Committee**

#### **Objective:**

To steer the transition process with the ultimate aim of establishing an independent, multi-service, deposit-taking, regulated, regional MFI for the Palestinian people.

#### **Composition:**

Three (3) members:

- MMD Board Member
- MMD Managing Director
- Senior External Transition Advisor

#### **Roles and Responsibilities:**

- Provide oversight for the overall transition process;
- Secure Board approval of transition plan;
- Oversee the business planning process and development of prospectus;
- Oversee development of strengthened financial structure;
- Approve technical staff involved in the transition process;
- Guide the development of new governance and ownership structure;
- Work to secure necessary regional licensing;
- Help identify and engage potential investors;
- Develop shareholder's agreements;

#### **Meetings:**

Weekly

### **Senior External Transition Advisor**

**Objective:**

To provide strategic advice from a private local financial and business perspective in order to provide help guide and strengthen the positioning of the transition within the local political and economic framework.

**Role:**

Act as the local champion. As an independent external professional, this person will provide objective outside input to the development and execution of the transition plan.

**Profile:**

- Impeccable reputation in the local environment
- Prestigious background
- Highly connected
- Entrepreneurial
- Knowledgeable of finance and business
- Convinced by and committed to the transition objectives
- Orientation as a socially responsible investor

**Roles and Responsibilities:**

- Help guide transition process;
- Identify strategic partners and potential Board Members in new company;
- Liaise with local institutional and individual investors.

### **Transition Advisor/Specialist (29)**

**Objective:**

Provide technical support for all aspects of the transition process. The objective of the position is to ensure that MMD successfully achieves its status as a finance company and then as a bank while continuing to focus on its core business. The Transition Advisor/Specialist will coordinate all activities of the transition, and will be responsible to and report to the Board through the CEO and the TC.

**Profile:**

- Local
- Finance/banking specialist – who could potentially take over as senior management in new bank
- Financial planning, management, analysis and modeling in a financial institution
- Substantial operations management experience in successful microfinance institution; and/or commercial banking or other financial institutions experience, especially in operations and treasury management
- Management of investor relationships

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29 Ledgerwood, Joanna and Victoria White, “Transforming Microfinance Institutions: Providing Full Financial Services to the Poor”; World Bank and Microfinance Network. Washington, DC 2006.

- Ability to provide direct technical assistance in a number of operational areas envisaged in the transition process, including but not limited to: MIS, strategic and business planning, financial management, treasury management, institutional development, internal audit, operations, policies and procedures; etc.

**Roles and Responsibilities:**

- Work with management to oversee and implement business plan, transition plan, bank preparedness plan, operational adjustments, reporting requirements, MIS integration, staffing needs, skills development.
- Provide technical support to the Steering Committee and management for implementation of transition activities.
- Review and refine the Transition plan, budget, activities, and timeframes.
- Set key performance indicators to measure and regularly report on transition status to Board and management.
- Identify and engage legal counsel to conduct the necessary legal due diligence for researching each step of the transition process including the appropriate capital structure, tax issues and capital requirements.

**Specific Activities:**

The Transition Advisor/Specialist shall be responsible for the following:

- Review the Transition plan and budget
- Coordinate the TC meetings to ensure they are held regularly and as scheduled, and to ensure that all stakeholders are kept informed and involved in the process.
- Provide technical assistance to the TC and management in areas of own expertise
- Coordinate the implementation of all the activities laid down in the transition plan, including:
  - Activities for preparing the institution to comply with regulations;
  - Preparing the application and following up with the PMA;
  - Actual conversion into a regulated financial intermediary
- Coordinate the out-sourcing and utilization of technical assistance for the transition process, including:
  - Formulating scopes of work (SOWs) and terms of reference (TORs) and designing contracts
  - Writing proposals to donors and providers of technical assistance
  - Scheduling underlying activities
  - Assembling and providing background information,
  - Initial briefing
  - Ensuring quality control and compliance with contracts as well as transfer and integration of knowledge and skills to management
  - Receiving technical assistance implementation reports for submission to TC.

## Appendix Two: Suggested Reading List:

- Campion, Anita Campion and Victoria White, *Institutional Metamorphosis: the Transformation of Microfinance NGOs into Regulated Financial Institutions*. Washington D.C.: The Microfinance Network, 1999.
- CGAP Occasional Paper No. 8, “Financial Institutions with a “Double Bottom Line”: Implications for the future of Microfinance, July 2004.
- De Sousa-Shields, Marc and Cheryl Frankiewicz, “Financing Microfinance Institutions: the Context for Transitions to Private Capital”, USAID Micro Report #8, 2004.
- Deborah Drake, Deborah and Elisabeth Rhyne, Editors, The Commercialization of Microfinance, Kumarian Press, Inc. 2002.
- Elisabeth Rhyne, Elisabeth, *Mainstreaming Microfinance: How lending to the Poor Began, Grew, and Came of Age in Bolivia*. Bloomfield, CT: Kumarian Press, Inc. 2001.
- James Kaddaras, James with Elisabeth Rhyne, “Characteristics of Equity Investment in Microfinance,” April 2004.”
- Ledgerwood, Joanna and Victoria White, “Transforming Microfinance Institutions: Providing Full Financial Services to the Poor”; World Bank and MicroFinance Network. Washington, DC 2006.
- Ledgerwood, Joanna, *Microfinance Handbook: An Institutional and Financial Perspective*. World Bank, 1999.
- Nimal A. Fernando, Nimal A. “Micro Success Story? Transformation of Nongovernment Organizations into Regulated Financial Institutions”, Asian Development Bank, June 2004. This publication examines the ownership structure, expectations, and achievements of transformed institutions in Asia, Latin America and Africa. Available at: <http://www.adb.org/Documents/Studies/microfinance-success/default.asp>
- Rock, Otero and Saltzman, “Principles and Practice in Microfinance Governance.” ACCION International. Prepared under the USAID Microenterprise Best Practice Project, Development Alternatives. 1998.
- “Savings Mobilization Strategies: Lessons from Four Experiences,” Consultative Group to Assist the Poorest, Focus Note 13: August 1998.
- Silva, Alex, “Investing in Microfinance – Profund’s Story”, Small Enterprise Development Journal, Vol. 16, Number 1, March 2005, pp. 17-29.