The Portland Trust

The Credit Market in the Palestinian Economy

One of the most significant contributions of a healthy credit market is its ability to provide the financial resources required to start or expand a business. Most firms lack sufficient funds to fully finance upfront investment costs; therefore credit facilities play a crucial role in bridging the gap. For this reason the credit market is at the core of any real economy: by assisting investment (one of the key macroeconomic aggregates) it ultimately enhances a country's growth and development potential. Recent research suggests that the lack of effectiveness in MENA's financial sector is one of the main factors for the region's economic under-performance relative to other emerging markets in the past decade.[1]

In addition to providing investment capital, credit markets play a crucial role in supporting new and established businesses when they experience fluctuations in their cash flow streams. Such fluctuations not only make businesses more vulnerable, but they can also negatively affect private consumption and, as a result, increase poverty levels. This is especially true in the case of micro and small enterprises, self-employed workers and entrepreneurs in developing economies (due to seasonality and lack of insurance, among other factors). Therefore working capital and consumption credit is also fundamental to understanding how an economy can support its poor and vulnerable against unexpected negative economic shocks.

In the case of the Palestinian economy (as in most developing economies) the credit market is far from being complete or perfect. Moreover, those market imperfections are said to be 'contagious': a failure in the credit market is likely to be transmitted to other markets in the economy. Should a firm's economic activity be impeded or interrupted due to the lack of credit, employment opportunities will be foregone or lost, creating additional pressures in the labour market.

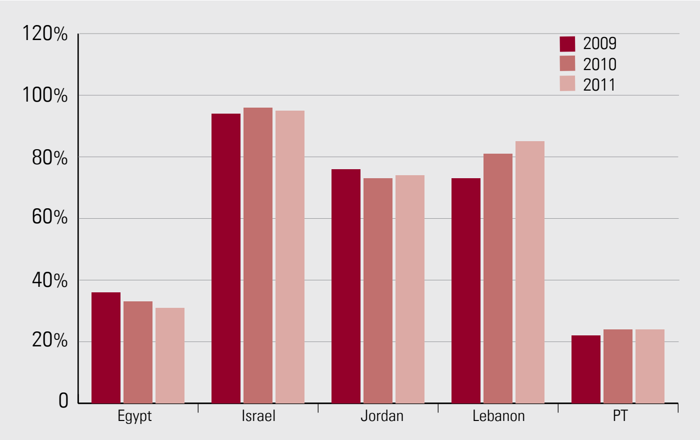
In order to understand the performance and prospects of the Palestinian economy, it is therefore crucial to review the characteristics of its credit market. With the lending-to-deposits ratio still at a relatively low level and the vast majority of Palestinian SMEs (which constitute the vast majority of establishments in the West Bank and Gaza) not connected to the existing formal credit channels, more needs to be done to enhance the credit market and thus empower economic growth and social and human development opportunities.

A Data-Based Snapshot

In a recent assessment of the MENA region's credit markets performance, the IMF pointed out that despite the region's economies' remarkable capacity to generate bank deposits,[2] bank lending to the private sector has fallen short during the past years.[3] Although the private credit to GDP ratio seems to be adequate at the aggregated regional level, each country's case is different. Non-GCC countries have been the least able to convert deposits into private sector loans and, even within this sub-segment, the Palestinian economy is outperformed by all its neighbours. In 2011, credit to the private sector represented only 24% of Palestinian GDP, while the figure reached much higher values of 95% in Israel, 85% in Lebanon and 74% in Jordan. Moreover, while in 2009 the MENA countries' average private sector credit to deposits ratio (~60%) was lower than that of emerging and developing economies worldwide (80%), in the West Bank and Gaza the figure reached a mere 23%. The IMF partly attributes this poor performance to heavy public sector borrowing (especially characteristic of the MENA region's non-GCC countries), which has intensified since 2010 in the case of the Palestinian Territory.

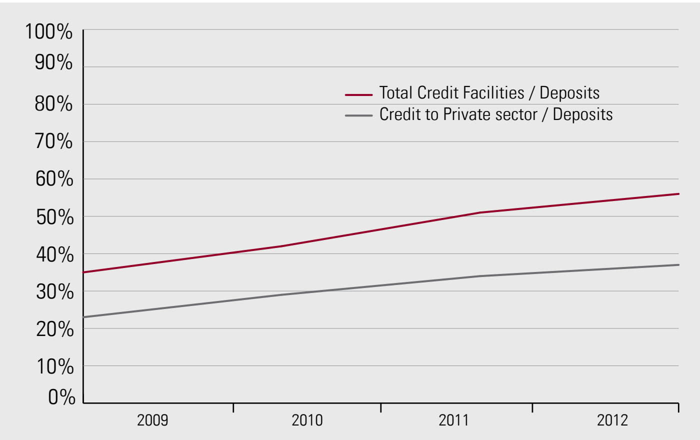
1 www.imf.org/external/pubs/ft/fandd/2013/03/barajas.htm
2 In the Palestinian case the growth in deposits can be largely attributed to the aggressive expansion strategies of local banks: the total 135 bank branches existent in 2004 more than doubled in 8 years to reach 227 in 2012.
3 www.imf.org/external/pubs/ft/fandd/2013/03/barajas.htm

Figure 1: Domestic Credit to the Private Sector (as % of GDP) – Selected MENA Countries



Source: PMA and World Bank's WDI

Figure 2: Total and Private Sector Credit to Deposits Ratio (Palestinian Territory)

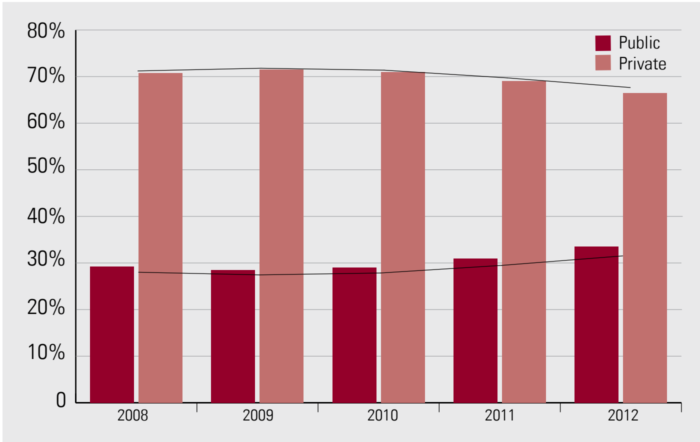


Source: PMA

From 2008, public sector lending as a share of Palestinian banks' total credit facilities grew steadily to reach 33% in 2012. As highlighted by the World Bank, the Palestinian Authority's (PA) stock of debt to local banks has been on the rise since 2008 and is becoming a source of concern for the otherwise well regulated and profitable local banking system.[4] Domestic credit facilities to the PA, which were around $0.5bn in 2008, increased to approximately US$1.4 billion as of December 2012 (a 180% increment). The current debt figure represents about 14% of the banking sector's total assets and 112% of its equity.

In a notable effort to minimise the potential impact of unexpected shocks on the banking system, the Palestinian Monetary Authority (PMA) has been carefully monitoring risks using quarterly stress tests. These tests suggest that the Palestinian banking system is resilient to a wide range of macroeconomic shocks, many of them related to its exposure to the PA's structurally fragile and volatile fiscal position. The PMA also requires banks to conduct semi-annual stress tests with scenarios tailored to their specific conditions. Thanks to these exercises, policies to strengthen the resilience of the banks are being developed by the PMA.

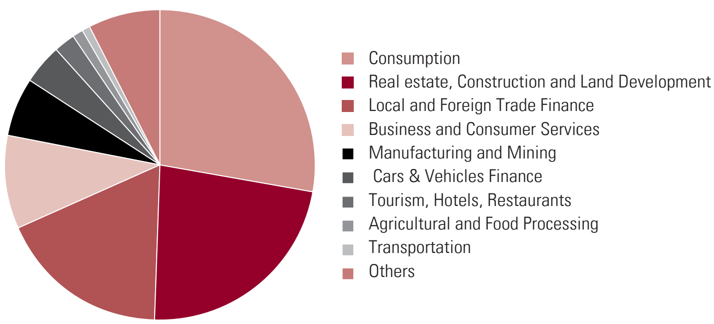
Figure 3: Credit Facilities by Sector (% of total – Palestinian Territory)



Source: PMA

In the last few years a number of efforts to stimulate private sector lending have been exerted by the PMA. For example, in 2009 the upper legal limit to deposits held abroad by Palestinian banks was reduced from 65% to 55%, in a move that is said to have brought around $700m back to the Palestinian banking system. Despite this and other efforts, much of the increased credit facilities did not end up financing private investment or SMEs activities: in Q4 2012 more than a quarter of the $2.8bn of credit available for the Palestinian private sector financed local consumption rather than production. While almost 23% of those funds went to construction and real estate activities, other important sectors in terms of growth and employment generation potential, such as agriculture and tourism, received a marginal part of total bank credit (1.3% and 0.8%, respectively). Even a core sector like manufacturing, at 4%, absorbed 50% less credit than that devoted to the financing of cars and other vehicle acquisitions.

Figure 4: Credit Facilities to the Private Sector by Economic Activity (Palestinian Territory – Q4 2012)



Source: PMA

4 www.siteresources.worldbank.org/INTWESTBANKGAZA/Resources/AHLCMarchfinal.pdf

Underlying Factors

A number of unique characteristics on both the credit demand and supply sides lie behind the current configuration of the Palestinian credit market. Although non-exhaustive, the review offered below aims to provide an initial overview to ignite further debate on the market's major challenges and what can be done to overcome them.

Supply side: are banks too conservative?

It is usually argued that Palestinian banks' lending policies are too conservative. But are the observed shortfalls in the offer of private sector credit for investment and productive activities a mere issue of risk-averse behaviour from the banks? As shown in Figure 2 above, the total credit to deposits ratio has effectively grown since 2008, although the main destination of those financial flows have largely been government borrowing and retail consumption financing. To provide a partial explanation to this, a number of sector experts argue that it is indeed 'simpler' (and more profitable) for the banks to lend to the government and private consumption segments. The reasons for this preference include their relatively lower risk, the lower transaction costs involved in the operations (given the predominance of fairly standardised administrative and risk analysis procedures) and the large sums involved due to the scale of the transactions.

Specifically, banks are said to have relatively easier procedures to lend to the PA and are capable of making solid profits from the average 4% interest rate paid by the government on the large sums it borrows. Moreover, lending to the retail segment tends to involve equally standard and simple administrative procedures and risks are relatively low given the banks' usual requirements to borrowers. Personal loans are typically exclusively granted to registered formal sector workers who are willing to transfer their salary payments to one of the lending bank's branches, which give the lender an immediate source of collateral. In some cases the borrower is also required to present one or two persons as his/her personal guarantor(s). Furthermore, average interest rates of around 11% for private sector loans denominated in NIS[5] are very attractive to the banks from a commercial standpoint in a market segment that has been expanding since 2008 following high GDP growth. Remarkably, the non-performing loan ratio has fallen steadily since 2007 to reach a very low 3.3% by the end of 2012.

Nevertheless, with the lending by private banks to the government at a near-limit rate and the retail market segment at a mature development stage (and slowing down following lower GDP growth in 2012) banks might find the right incentives to increase their focus on productive lending, mostly to SMEs (the 100 large firms operating in the West Bank are already banked and tend to be less credit constrained, therefore offering less untapped potential). However, consultation with some of the main banks indicates that, despite a number of new initiatives to approach SMEs by one or two institutions, risk analysis procedures to evaluate SME investment projects still remain broadly ad-hoc. Personal references and reputation remain instead important and the requirement of collateral in the form of land is the norm in most cases.

According to the Q1 2013 *Survey of the Perceptions of Owners / Managers of Active Industrial Enterprises*, all companies whose applications for bank loans were refused identified the lack of suitable guarantees as the main reason for the rejection.[6] While this specific need is being partially addressed thanks to the efforts of the loan guarantee facilities operating in the West Bank,[7] further progress is needed. On top of this, and as comprehensive and clear land registration continues to be a major issue in the Palestinian Territory,[8] most firms remain de-facto excluded from the credit market. This is largely because of their inability to meet the minimum required conditions, which prevents them from considering presenting their cases to financial institutions. Also banks' administrative requirements to companies, which usually follow international standards, tend to leave out most small and medium firms due to their inability to comply with such conditions. Finally, the fact that many of the main banks' boards are based in Jordan has been noted as an additional challenge to the ease of decision making by those financial institutions.

Demand factors: negative perceptions and lack of capabilities

The requirements mentioned above prevent the majority of SMEs from even attempting to apply for a loan. Following a long term trend, 98% of all Palestinian establishments refrained from requesting bank credit in Q1 2013.[9] Moreover, according to a survey conducted by the Palestinian Research Institute (MAS) in 2011, although more than 60% of firms claimed that they needed external financing, personal contributions generally constituted the prime source of funding for nearly 80% of SMEs. Bank credit came second, reaching a low of 8.2%.[10]

On top of the constraints imposed by bank requirements, pessimistic perceptions on the prospects of the economy dissuade businesses from investing. In Q1 2013 only 36.4%

5 Average interest rate for loans denominated in NIS during 2012. Source: PMA - www.pma.ps/index.php?option=com_content&view=article&id=108&Itemid=111&lang=en

6 www.pcbs.gov.ps/portals/_pcbs/PressRelease/Press_En_PercOMAI_EQ12013.pdf

7 Middle East Investment Initiative (MEII): www.meiinitiative.org / European Palestinian Credit Guarantee Fund (EPCGF): www.cgf-palestine.com/main.htm

8 Only 30% of the land in the West Bank is registered. The registration process is complex and lengthy, taking nearly fifty days and involving four institutions: Municipality government, Ministry of Finance, Commercial Bank and the Land Registry.

9 www.pcbs.gov.ps/portals/_pcbs/PressRelease/Press_En_PercOMAI_EQ12013.pdf

10 www.mas.ps/2012/node/51

of Palestinian Industrial establishments expected enhanced performance for the next quarter of the year.[11] The lack of an adequate environment for investment is partly fuelled by excessive governmental regulation and the existence of a distortive taxation scheme (as reported by numerous local business figures). More importantly, the numerous restrictions to the autonomous development of the Palestinian economy imposed by the Israeli control over vast sections of the West Bank (including limitations to movement and access), further damages the business climate.

Finally, in the SME segment, the existence of a technical skills gap among most companies represents a further hindering factor for credit demand. Rami Khoury, head of the Middle East Investment Initiative (MEII - a non-profit operating a $160m loan guarantee facility in the Palestinian Territory), claims that despite the efforts on the development of loan guarantee and risk mitigation programmes it is not rare to see prospective firms struggling to put together a 'proper' business plan to present to the banks. Khoury argues that this is partly related to lack of relevant expertise and initiative from the firms and that more needs to be done to bridge the gap between both ends of the market. In his words '*banks definitely need to move towards SME-friendly alternatives but it is as important that SMEs get closer to the banks by presenting them with more attractive packages. If banks identify possibilities of closing good deals with the SME segment they will undoubtedly go for it.*'

Remaining Challenges

Dr Samir Abdullah, director general of MAS, argues that '*finding adequate solutions to the funding problem of SMEs will have a major overall impact, due to the significant contribution of these enterprises to the Palestinian economy and the fact that they are widely spread, both geographically and at the sectorial levels.*'[12]

Thus a number of measures can be adopted (by both the public and private sectors) to further realise the potential of the Palestinian credit market, which will ultimately enhance local economic performance. These include:

- The adoption of an appropriate legal and organisational framework capable of effectively stimulating SME financing, including less burdensome procedures that ensure the protection of both creditors and borrowers;
- The setting of a minimum proportion of credit facilities to be provided by banks and other financial institutions to the SME segment;
- The creation of a united national fund specialised in providing loans, financial incentives and technical assistance to SMEs (especially focusing on entrepreneurs);
- The granting of financial benefits and tax exemptions to institutions lending to SMEs; and
- The continued support and expansion of the funds for guaranteeing SME loans.

Despite these remaining challenges, consultation with banks indicates that there is growing interest in further developing the SME lending segment by offering new credit products tailored to the needs of those firms. The public sector is also aware of the importance of the credit market for future development of SMEs. Following the recommendations of the fourth International Banking Conference held in Jericho in February 2013[13], the PMA recently issued new regulations to help SMEs with defaulted loans to normalise their credit status with banks and to stimulate lending by liberating additional bank capital for SME credit.[14]

The effectiveness of these developments will greatly depend upon the improvement of the general business environment and private sector perceptions of the economy, both ultimately affected by political instability and the PA's structural financial crisis.

11 www.pcbs.gov.ps/portals/_pcbs/PressRelease/Press_En_PercOMAI_EQ12013.pdf
12 www.mas.ps/2012/node/51
13 www.bit.ly/Zdi1xF
14 www.bit.ly/1946hPG Consultation with PMA

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