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THE WORLD BANK

WEST BANK AND GAZA

FINANCIAL SECTOR REVIEW

December 2008

Finance and Private Sector Group
Social and Economic Development Department
Middle East and North Africa Region

WEST BANK AND GAZA—GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of April 8, 2008)

Currency Unit	=	New Israeli Shekel (NIS)
US$1	**=**	**3.58**

WEIGHTS AND MEASURES
Metric System

ACRONYMS

ACH	Automated Clearing House
AMAL	Affordable Mortgage and Loan Company
ATM	Automatic Teller Machine
BOI	Bank of Israel
CAEL	Capital Asset Earning Liquidity
CAMELS	Capital Asset Management Earning Liquidity Sensitivity
CHF	Cooperative Housing Foundation
CMA	Capital Market Authority
DFID	Department for International Development
EU	European Union
FFU	Financial Follow up Unit
FSDI	Financial Sector Development Indicator
GDP	Gross Domestic Product
GDPPC	Gross Domestic Product per capita
GPIC	Gaza Pension Insurance Corporation
IAS	International Accounting Standard
ICA	Investment Climate Assessment
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial Public Offering
KfW	Kreditanstalt für Wiederaufbau
LGP	Loan guarantee program
LGF	Loan guarantee facility
MENA	Middle East and North Africa
MFIs	Micro finance institutions
MOD	Ministry of Defense
MOU	Memorandum of understanding
NGO	Non governmental organization
NPLs	Non performing Loans
OPIC	Overseas Private Investment Corporation
PA	Palestinian Authority
P/E	Price / Earnings
PIF	Palestinian Investment Fund
PMA	Palestinian Monetary Authority
PMCH	Palestinian Mortgage and Housing Corporation
PSE	Palestinian Stock Exchange

POS	Point of Sale
RTGS	Real Time Gross settlement system
SME	Small and Medium Enterprise
STRs	Suspicious Transaction Reports
VAT	Value added tax
WBG	West Bank and Gaza

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Preface and Acknowledgments

This Financial Sector Review was undertaken during May and June 2008 and analyzed the structure and infrastructure of seven WBG financial subsectors. The team was composed of Laurent Gonnet (banking and payments system), Henry N. Schiffman (securities market, insurance, financial leasing, and microfinance), Olivier Hassler (housing finance), and Csaba Feher (pensions).

The planned scope of the review was focused on the provision of existing financial services and on policy and institutional factors affecting financial sector development with a view toward assessing the adequacy of the existing structure and infrastructure to support expanded economic activity. Therefore, the review asked which financial services are provided, who are the providers, what is the regulation and supervision for financial subsectors and are they appropriate, and what is being done to develop the markets for each of the financial services subsectors. Thus, the review is structured accordingly with each section of the report including basic subsections on: (i) providers and products; (ii) regulation and supervision; and (iii) market development.

The World Bank Group greatly appreciates the close cooperation of Dr. Jihad K. Alwazir, Governor of the Palestinian Monetary Authority (PMA) and Dr. Atef Alawneh, Director General of the Capital Market Authority (CMA) that facilitated the work.

The team is also appreciative of the support received in meetings with Mr. Riyad M. Abu Shehadeh, Director of the Banking Supervision Department (PMA), Ms. Shireen Z. Al Ahmad, Risk Management Unit (PMA), Mr. Bashar O. Yasin, Payments system Project Coordinator (PMA), Mr. Mustafa S. Abu Salah, Section Head Commercial Foreign Banks, Banking Supervision Department (PMA), Shereen S. Abueid, Supervisory Development Officer (PMA), Mr. Khalil Haj Ali, Manager Audit and Financial Analyses Department, Insurance Control department (CMA), Mr. Farid K. Karajah, Technical Manager, Insurance Control department (CMA), Mr. Jiries Qassis, General Manager, Securities Surveillance Administration (CMA), Mr. Malek Khader, General Manager Mortgage Housing and Lease Financing (CMA), Adv. Amjad Badran, Legal Assistant, Legal Affairs Department (CMA), Mr. Saad Khatib, Secretary General, Palestinian Federation of Industries, Mr. William J. Phelps, Managing Director, CHF International, Mr. John P. Khoury, Director, European Palestinian Credit Guaranty Fund, Mr. Sufyan Awad Ahmad Barghouti, Ramallah Branch Manager, Palestinian Stock Exchange (PSE), Mr. Faten H. Taneeb, Operation Manager, PADICO, Mr. Amjad Y. Hassoon, Financial Manager, PADICO, Mr. Sami Saidi, General Manager, Alrafah Microfinance Bank, Mr. Mazen Abu Hamdan, Regional Manager, Arab Bank plc, Mr. Odeh Shehadeh Zaghmouri, CEO, Wassel, Mr. Joseph Nesmas, Assistant General Manager, Cairo-Amman Bank, Mr. Atiyeh A. Shananier, Arab Islamic Bank, Mr, Hani S. Naser, Regional Manager, Bank of Palestine, Ms. Reem H. Abboushi, Executive Director, Palestinian Business Women's Association, Mr. Iyad Nabulsi, Microfinance Coordinator, United Nations Development Programme, Mr. Yacoub Hadwan, General Manager, Goodluck Car Rental and Leasing, Mr. Aziz M. A. Jawad, General Manager, National Insurance Company ltd, Ms. Hiba I. Husseini, J.D., Attorney, Husseini and Husseini.

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FINANCIAL SECTOR REVIEW

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EXECUTIVE SUMMARY

i. The formal financial sector in WBG emerged some 15 years ago, after 1993-1994 with the signing of the Oslo Accord in 1993 and the Paris Protocol in 1994. The latter provided Palestinians the authority to administer monetary and financial affairs in order to support the expected economic growth.

ii. Those expectations were never fully realized because of on-going restrictions on mobility of persons and goods and on access to natural and financial resources imposed by Israel. In the last several years the Palestinian economy has been in steady decline. Per capita GDP is estimated to have fallen by nearly 30.0 percent from its height of USD 1610 in 1999 to around USD 1,130 in 2006. Except for a short period between 2003 and 2005, when the economy was recovering, growth was negative every year since 2000. During the last two years the decline has accelerated. GDP contracted by nearly 8.8 percent in 2006 and by 4.2 percent in the first quarter of 2007. In 2007 the growth rate was near zero and in it is projected to be only one percent in 2008.

iii. In spite of the difficult environment, the Palestinians have managed to establish a financial sector composed of most of the expected sub-sectors: banks, a securities market, insurance companies, payments system, housing finance companies, microfinance institutions and financial leasing companies. Yet, important needs for financial services have not been met (for micro-credit, households, and SMEs).

iv. The Palestinian Authority (PA) has established two main institutions to regulate and supervise the financial sector: the Palestinian Monetary Authority for the banking sector (as well as payments system, micro finance institutions and money changers), and the Capital Market Authority for the non-banking sector (securities market, financial leasing, mortgage finance companies, pension funds, and insurance companies). The development of those subsectors, as well as the regulatory bodies, is uneven and the PA's monetary powers and sovereignty remains limited since it has no national currency, which therefore narrows the scope for influencing monetary and economic conditions.

v. Assuming that the potential of the West Bank and Gaza economy is unleashed, which would require a major dismantling of today's closure regime, the financial sector, as it appears now, would be ready to play an active role. That said, the PA should continue to refine and strengthen this sector to improve its functioning under the current constraints. Those efforts would also fully benefit the West Bank and Gaza economy if and when the political situation eases. In the meanwhile, the PMA should pursue its goal of becoming a full-fledged central bank, while the CMA would benefit from capacity building support so they can play a more effective role as regulator of the various sub-sectors for which it is responsible.

Banking Sector

vi. As in most developing countries, the banking sector dominates the financial sector. Banks are generally in sound financial condition and products are well developed as is the regulatory infrastructure. However, the sector remains vulnerable due to its dependence on the Jordanian banking system and, from an operational point of view, on the Israeli one. Due to a large extent to the current political instability and to the depressed economic activity, banks play a very limited role in the financing of the WBG economy. The cautiousness of the banks reflects various structural problems such as the lack of suitable collateral and the uncertainty of the outcome in debt collection. Important steps have been taken by the PMA to develop the banking system and improve its stability (credit bureau, payments system, capital requirements and regulations on secured credit). Additionally, two bank loan guarantee programs to largely substitute for the lack of acceptable collateral for small and medium enterprises (SMEs) were successfully launched. Despite the current economic situation, those programs should continue to expand.

vii. While the current efforts of the PMA to develop the sector should continue including enactment of a new banking law to provide better basis for implementation of all of the Basel Core Principles, extending the network of the credit bureau, and completing the installation of the payments system, the PA should also consider strengthening the financial infrastructure by promoting out-of-court settlement for debt collection and establishing a national registry for pledges of movable property to increase the array of collateral likely to be accepted by banks to secure credit facilities.

Payments System

viii. The payments system has a number of weaknesses and vulnerabilities which are magnified by the multi-currency status of WBG as well as the movement and access restrictions resulting from the closure regime. While some banks have electronic payment instruments for their customers, WBG remains mainly a paper-based financial transaction economy with cash being the dominant payment medium for the general public. Aware of the weaknesses and the importance of an effective and comprehensive payments system for the development of the WBG economy, the PMA, with the assistance of the World Bank, has embarked on a modernization program. Systemic risk will also be reduced by the planned introduction of liquidity management functions.

ix. With regard to non-banking sector, insurance and microfinance are fairly well developed while financial leasing and housing finance have emerged only recently, private pension funds have yet to be established and the regulation and supervision of this sector began only 2 ½ years ago.

Securities Market

x. The capital market, which consists of underwriting of share issues and trading of shares on the Palestinian Stock Exchange (PSE), began 10 years ago. The activity is regulated by the CMA and the PSE, according to an allocation of responsibilities which should be clarified. Given the predominance of SMEs and family-owned enterprises in the WBG economy, there are only 35 listed companies thus far and the potential for new applicants appears limited. The PSE is thinly traded and the index is relatively high and very volatile, which could potentially amplify economic shocks. This situation reflects the fact that rumors rather than economic fundamentals move prices and also that numerous individual investors with limited financial knowledge buy shares directly on the stock exchange.

xi. Given the current situation, the CMA may want to consider various measures to develop the market such as the establishment of professionally managed investment funds for investment in securities, the definition of its respective regulatory and supervisory roles vis-à-vis the PSE and the development of a bond market. Also, the PA may wish to consider amending the Law of the CMA to give it more political independence.

Insurance

xii. With 2.5 percent of the financial sector's assets, insurance companies do not play the role as those in other countries as important institutional investors. The contribution of insurance premia to GDP was only 1.6 percent in 2006 while the spending on insurance per capita was about USD 18 compared to the average of 2.7 percent and USD 60 in developing countries. This situation mainly reflects depressed economic activity, transit restrictions and limited public awareness of insurance products.

xiii. The insurance industry was not supervised for ten years until 2005 and remedial supervisory measures are underway by the CMA. Insurance products are varied but overall income has declined due to the marked reduction in underwriting of compulsory motor vehicle insurance. The legal and regulatory infrastructure for insurance is based on international practices and the Council of Ministers and CMA have issued prudential and market conduct regulations. Market development depends mostly on an increase in economic activity though some new products were recently introduced that are promising. The CMA should endeavor to strengthen companies' operations to enable them to qualify for high international ratings and for reinsurance of a major portion of their liabilities by highly rated reinsurance companies.

Financial Leasing

xiv. Financial leasing is in its infancy. There are four active companies leasing mainly motor vehicles for commercial fleets. Some basic regulations have been issued by the CMA and a leasing law is under development. That law may stimulate more interest in the activity. The CMA should issue market conduct regulations and the companies should develop a consumer education campaign to promote financial leasing of commercial and industrial equipment in addition to automobiles.

Housing Finance

xv. Housing needs are great in WBG, but price levels and spatial restrictions, partly due to the on-going Israeli settlement activity in the West Bank and the existence of restricted roads and areas, constrain the effective demand while products available for finance housing demand are too limited. The Palestinian Mortgage and Housing Corporation (PMHC) that provides refinance and mortgage guaranties had a catalytic effect in the emergence of mortgage lending but has lost its attractiveness for primary lenders. The Palestinian Investment Fund (PIF) is working on late stage plans to help address housing and mortgage finance needs by developing a large-scale, affordable housing project and is in advanced negotiations to establish a mortgage finance company.

xvi. To further develop the market, the PA should improve the legal and regulatory environment (strengthening and modernization of the mortgage lending framework, development of a framework for the financing of housing development, and alignment of CMA and PMA regulations in respect of mortgage lending and housing finance) and take steps to foster market development and facilitate access to housing by moderate income groups an conjunction with the PIF initiative. This should include, *inter alia*, the reform of the PMHC to improve its services to the market and the building of lender's capacities. The adoption by the CMA of appropriate prudential and market conduct regulations will also be key element for the emergence of a sound housing finance sector.

Microfinance

xvii. Microfinance is well developed in its offering of products that are essentially only credit but apparent needs far exceed the funding capacity at present. Funding is by donors and reinvested profits. MFIs are not currently sustainable.

xviii. Operations infrastructure of the nine nonbank providers is being strengthened and a regulatory framework is being developed by PMA that should require MFIs to be organized as companies with effective corporate governance structures and procedures and contain rules for market conduct. If MFIs were permitted to take deposits from the public or convert to banks with moderate regulatory requirements, as acknowledged by the Basel Committee on Banking Supervision, it would enable MFIs to become sustainable. Moreover, profitable and expanding MFIs should result in those institutions providing access to finance for the middle market (households and SMEs), thereby creating a financing continuum in the customer spectrum.

Pension Funds

xix. There are no privately managed pension products in WBG and the domestic financial sector currently lacks entities other than insurance companies which could offer or manage pension products. There are too few regulations in place for the provision of either pension products or the underlying products and services. The CMA would need technical assistance to train its personnel, develop the necessary regulatory framework, and establish bilateral supervisory agreements with regulators in other countries.

Legal Framework

xx. The general legal framework supporting the financial sector should be considerably modernized and its enforcement made more efficient. The company laws applicable in WBG do not reflect the revolution in corporate governance in recent years. A corporate governance code is being developed but is reported to be only voluntary. For creditors' rights there should be modern rules for creation, registration and enforcement of pledges of moveable property. Some debt collection procedures are efficient but regular court proceedings are protracted and outcomes would benefit from modern case management and training of judges in commercial and financial matters.

Recommendations for Reforms

xxi. The recommendations for reforms in this report are summarized in Section IX. Those and the actions undertaken and planned by the PMA and the CMA would provide an adequate financial sector structure and infrastructure to support expanded economic activity. In that respect, these actions would support the Palestinian Reconstruction and Development Plan which recognizes the importance of private sector development to meet its goals.

xxii. Additionally, a comprehensive Financial Sector Development Plan could be considered, including monetary policy management issues (limitation of number of currencies, establishment of a money market, issuance of PA bonds). In any event, since there is no entity in WBG with responsibility for reform of the overall financial sector, the establishment of a steering committee composed of the main financial sector stakeholders, would seem to be appropriate to coordinate technical cooperation and to keep reform efforts on track.

I. THE BANKING SECTOR

A. Providers and products

1. **The banking sector, which dominates the financial system in WBG[1], is relatively new.** Before 1993 there were only two banks operating (Bank of Palestine and Cairo-Amman Bank). Some banks, which had ceased operations in WBG after 1967, reopened in 1994 and new ones were established rapidly. In December 1995, there were 16 banks; as of May 30, 2008, there were 21 banks (see Appendix 1).

2. **Despite the declining economy and the politically unstable situation in WGB, the banking sector appears to be relatively sound (see Box 1)**.[2] The total assets of the banking sector steadily increased from USD 4,885 million in 2004 to USD 6,704 million in 2007 while the net income increased from USD 36 million to USD 68 million over the same period. Over the four last years, return on assets and return on equity were respectively 1.3 percent[3] and 15.9 percent.

Table 1: Assets & Profits of Banks in WBG (2004-07)

(in thousands of USD, as of end year)

	2004	2005	2006	2007
Total net assets	4 884 635	5 398 530	5 522 219	6 703 853
Net interest	96 890	139 688	173 258	205 475
Net profits	35 965	111 018	51 500	68 225

Source: PMA

Box 1: Banks' Recovery from Political Turmoil

Banks were adversely affected in 2006 when the Hamas government that assumed office in March 2006 and donors cutoff aid forcing the PA to stop paying salaries. As a result, classified loans rose from USD 156 million to USD 422 million between 2005 and 2006. To avoid the insolvency of the banking system (the amount of needed provisions according to the applicable regulation would have absorbed all the regulatory capital of the banks), the PMA allowed the banks to assess their provisioning needs other than in compliance with the regulation. In return, the PMA required banks to increase their capital. The paid-in capital rose from USD 316 million to USD 482 million between 2005 and 2006 (+53 percent). The PMA recently decided to raise the minimum capital to USD 35 million as a means to increase the soundness of the banking sector and to encourage small banks to merge. At the time of the mission, there were two troubled banks, which accounted for less than 3 percent of the system's deposits.

After the new government took charge, the payment of the PA salaries resumed and the classified assets started decreasing. The improvement was from USD 422 to USD 315 million (the PA employees' bank loans decreased from USD 226 million to USD 118 million). Everything else being equal, the provisioning rate, which was 35.9 percent of the classified loans in 2006 and 61.1 percent in 2007, should continue to increase.

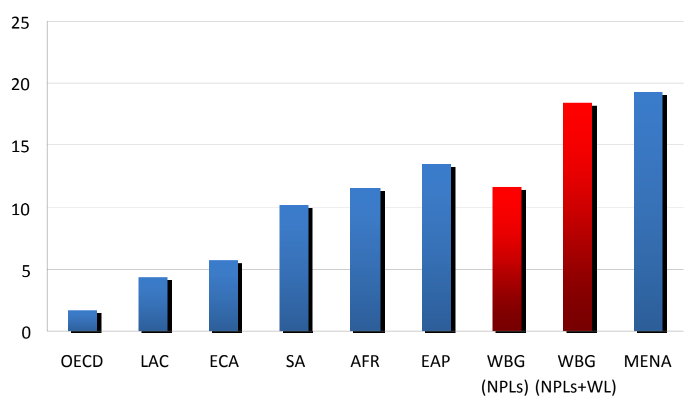
[1] The aggregate balance sheet of banks is USD 6.7 billion, compare to a stock exchange capitalization of USD 2.5 billion and total insurance companies assets of USD 0.2 billion.
[2] Because of capital increases and forbearance in provisioning in 2006, the aggregate capital adequacy ratio (for local banks) rose from 13.8 percent in 2005 to 21.4 percent in 2007. Nevertheless, the non-performing loans (NPLs) excluding the PA employees' loans steadily increased and stand at USD 197 million; i.e., 11.6 percent of the total loans (or 18.5 percent including the PA employees' loans). The NPLs to total assets ratio is 2.9 percent (4.7 percent with the PA employees' loans).
[3] The average ROA in the MENA region is around 1.4 percent.

Table 2 : Aggregate Loan Portfolio Quality of Banks in WBG (2004-07)
(in thousands of USD, as of end year)

Classification	2004	2005	2006	2007
Performing	1 217 702	1 585 454	1 420 912	1 390 145
Watch list (1 – 3 months)	5 916	7 884	225 634	118 009
Subs. & Doubtful (3 – 12 months)	9 763	2 104	37 631	16 091
Loss (> 12 months)	138 993	145 932	159 204	180 923
Total loans	1 372 374	1 741 375	1 843 382	1 705 168
NPLs loans	148 756	148 036	196 835	197 014
NPLs + watch list	154 672	155 920	422 469	315 023
Specific provisions	133 780	139 784	151 793	192 499
Paid-in capital	277 284	316 270	481 566	530 393
Ratios (%)				
NPL ratio	10.8	8.5	10.7	11.6
NPL + Watch list ratio	11.3	9.0	22.9	18.5
Coverage ratio NPL	89.9	94.4	77.1	97.7
Coverage ratio NPL + Watch list	86.5	89.7	35.9	61.1

Source: PMA.

Figure 1: Non Performing Loans (% total loans)



3. **Two factors contributed to maintaining a relatively sound banking system in WBG**: The majority of the banks' assets are held in foreign countries, in bank placements and investments in debt and equity securities, which to an extent protected them against the internal economic downturn; and the public's confidence in the banking system manifested itself by continued deposits in banks, despite the absence of an explicit deposit guarantee scheme.

4. **However, the Palestinian banking system remains vulnerable to three structural factors:**

- The WBG banking industry is dominated by a single foreign banking sector. Indeed, the Jordanian banks receive 65.4 percent of the deposits and account for 35.9 percent of the loans to the WBG economy as for December 2007. While the presence of foreign banks has stimulated development of the local banks in many respects such as IT systems, risk management techniques and new products, this concentration poses a potential systemic risk since in the event of any adverse development abroad, it is likely that the Palestinian banking system would be adversely affected.

- From an operational point of view, the banking system in WBG is highly dependent on the Israeli one (especially for the operations in NIS). End 2007, the two Israeli commercial banks dealing with Gaza's financial institutions (including Israel's biggest bank) contemplated severing ties to the Gaza banks after Israel declared Gaza "hostile territory". This decision threatened the physical transfer of NIS bank notes used by the PA to pay salaries to tens of thousands of its employees in the Gaza Strip (NIS are also needed to pay for imports, mainly from Israeli suppliers). In that situation, banks in Gaza started refusing to cash large cheques and limited cash withdrawals. Thanks to close cooperation between the PMA and the Bank of Israel (BOI), a solution was found that probably avoided a run on banks in Gaza. Since the issue re-emerged recently (see Box 2), both the BOI and the PMA continue to collaborate in order to find a satisfactory solution to this issue.

- The fact that WGB has no national currency exposes WBG banks to foreign exchange rate shocks more than banks in most other jurisdictions. Banks have assets and liabilities in three currencies, USD, NIS, and JOD.

5. **The financial services of WBG banks are developing but the supply of credit does not fully meet the demand**. The licensing policy adopted by the PMA since 1994, which consisted of admitting affiliates of well managed and modern foreign banks, contributed to the expansion of a wide array of products in WBG. Among the services available are debit cards, ATMs nationwide for international cards, cheques, money orders and saving accounts. One bank offers telephone and Internet banking. In terms of credit facilities, banks provide loans and overdrafts. However, there are some deficiencies. Only 9 out of 21 banks provide mortgage loans. With regard to commercial finance, few banks offer leasing while there is no factoring in WGB. In terms of loans, according to the Palestinian Federation of Industries, banks too often propose overdrafts whereas term loans would better suit the firms' needs.

Box 2: Currency in Gaza

Since the Hamas takeover of Gaza, it has become increasingly more difficult to transport currency in and out of the Strip. Despite established protocols, the MOD/Erez Security is preventing the entry and exit of armored trucks that transport currency. The Bank of Palestine and others have a total of NIS 60 million in unfit shekel banknotes that ordinarily it would send to Israel to exchange for new banknotes. In addition, Bank Hapoalim's plans to suspend correspondent relationships has led Gazan merchants to withdraw funds from the local banks and conduct all business in cash. This has led to a liquidity crisis, which recently reached a climax when the PA was short by NIS 100 million to make June 2008 salary payments. The PMA managed to resolve this through informal arrangements. However, unless Israel removes its restrictions on the entry of NIS, the PA will not be able to make salary payments in Gaza. Also, the private sector will not be able to benefit from an opening of the crossings due to the lack of sufficient shekels. The private sector may end up using dollars, which would benefit Hamas which is managing a parallel market in foreign exchange.

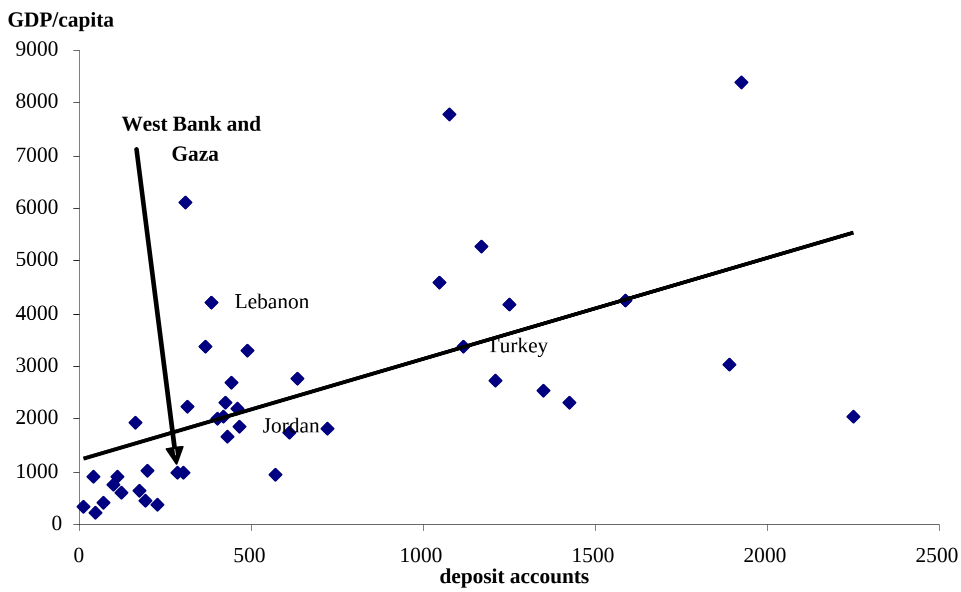
B. Access to banking services

The banking system is successful in attracting public savings but a large part of the Palestinian population is unbanked

6. **Except in 2001 and 2002, total deposits steadily increased to USD 4.6 billion in 2007, which became larger than the GDP (USD 4.5 billion).** Even in 2006, which witnessed the cut off of donors' assistance and tax revenue remittances by Israel and led to an economic decline, the deposits continued to grow in WBG. Beyond the confidence of the public in the WBG banking system, this reflects the impact of remittances and aid. WBG deposit ratio[4] of 102 percent is close to those observed in developed countries and well above the MENA region, which is around 60 percent.

7. **Still, a large segment of Palestinians do not use or have access to the banking system**. There are 1.5 million banking accounts (deposit and checking) in WBG but this figure is inflated due to the multicurrency status of the Palestinian economy. Assuming that, because of the use of multiple currencies, 60 percent[5] of the population needs to have banking accounts in more than one currency, the number of banking accounts would otherwise be roughly 850,000. In comparison with other developing countries, WBG ranks relatively low with 200 deposit accounts per 1,000 persons, as shown in the following chart.

Figure 2: Deposit accounts per 1,000 persons & GDP / capita



Source: World Bank, Finance for all? Policies and pitfalls in expanding access, 2007.

[4] Total deposits / GDP
[5] This percentage, based upon staff interviews and questionnaire, appears to be the most conservative.

The volume of credit to the private sector has decreased and stands at a very low level

8. **Between 2005 and 2007, the banking sector in WBG slightly increased the volume of credit to the private sector from USD 1,150 million to USD 1,277 million.** The level of credit to the WBG economy may be more the consequence of a regulatory requirement for banks to allocate no less that 40 percent of their deposits in credit to the WBG economy (although the requirement is not met) than banks' real appetite for the market. The decrease in credit to the public sector, which needed less banking financing in 2005 and 2006, supports this finding. This trend suggests a potential crowding out effect since it appears that, under the regulatory constrain, banks would prefer lend to the public sector instead of the private sector.

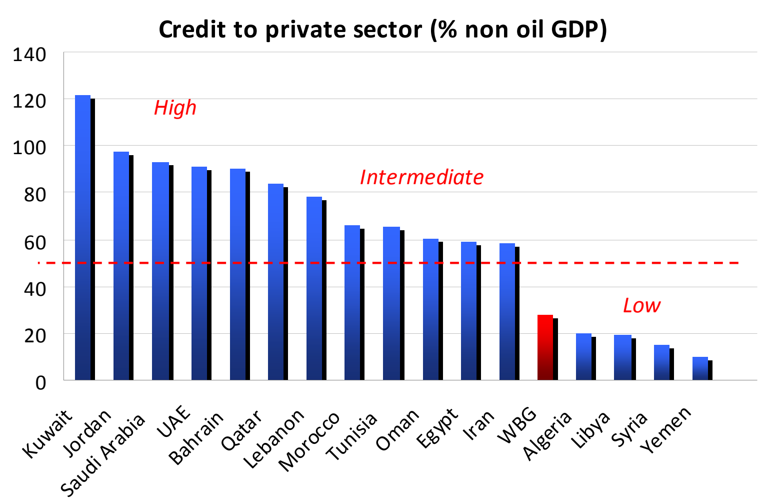
Table 3: Breakdown of Gross Credit of Banks in WBG to Public and Private sectors (2004-07)
(in thousands of USD, as of end year)

	2004	2005	2006	2007
Public sector	443 957	591 094	482 740	427 806
Private sector	928 417	1 150 281	1 360 642	1 277 362
Total loans & advances	1 372 374	1 741 375	1 843 382	1 705 168
Ratio (%) Private sector to GDP	22.8%	25.7%	30.9%	28.3%

Source: PMA.

9. **With a ratio of credit to private sector credit to GDP of around 28 percent, WBG ranks among the lowest in the MENA region where the average percentage is around 50 percent (see Figure 3).** Moreover, a large percentage of the credits are extended in the form of overdrafts, enabling banks to cut the facilities at short notice.

Figure 3: Credit to private sector



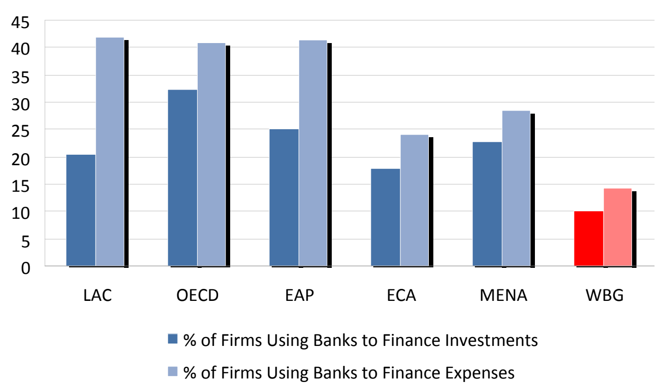
10. **Microeconomic data support these figures**. Concerning credit to households, consistent with the low number of bank accounts among the Palestinian population, WBG ranks low in

terms of number of loans per 1,000 inhabitants. Indeed, with 10 loans for 1,000 persons, it is ten times less than the average ratio for developing countries (100 loans for 1,000 persons[6]).

11. **With regard to credit to firms, everything else being equal, it is likely that access to credit would become a more major constraint if and when the mobility of goods and persons is expanded.** The 2006 Investment Climate Assessment (ICA) survey indicators show that the main obstacles faced by WBG firms are political stability (45.1 percent), electricity supply (11.2 percent), access to finance (10.7 percent) and transportation (10.7 percent).

12. **That said, 37 percent of surveyed firms stated that access to finance is a "major or severe problem," which is more than in many other countries** (see Appendix 2 - first chart). The constrained firms (see Appendix 2 - second chart) represent firms excluded because their credit application was denied (1.6 percent) or because they were dissuaded from applying for a loan (27.5 percent)[7]. The small percentage of denied applications is consistent with the banks' reports during the mission. Consistent with the general complaint, the percentage of firms having access to credit to finance their investments and their working capital (see Figure 4) is the lowest of the MENA region.[8] Additionally, banks require high amounts of collateral, 158 percent of the value of the loans, compare to an average of 145 percent in the MENA region.

Figure 4: Use of bank finance



13. **Still, small Palestinian firms, which constitute the bulk of the firm population, appear to be among the most deprived of credit in the world.** Indeed, 9 percent of small firms use credit to finance their working capital, which is well below the averages observed in other

[6] In 33 developing countries.
[7] This figure (27.5 percent) takes into account the following reasons for not applying for a loan: complex application procedures, interest rate not favorable, collateral requirement unattainable, size/maturity of loan insufficient, did not think the loan would be approved, religious reasons (religious reasons include people who don't find credits that are compliant to their religion and people who don't borrow for religious reasons – since it is impossible to distinguish the two aspects, people who don't borrow for religious reasons are included in the results).
[8] These comparisons must be cautiously analyzed since the sample used in the ICA survey carried out in WBG overweights the segment of small firms (62 percent of the surveyed firms comprise between 1 and 19 employees versus an average of 35-40 percent in the other ICAs) which are, by nature, more constrained than the larger corporates.

regions (such as the Sub-Saharan Africa region with 13.4 percent of small firms using bank credit to finance a part of their working capital).

14. It should be emphasized that the figures on the perceived constraints were collected in 2006, at a time when firms decreased their demand for credit, especially for investments[9]. If the survey had been carried out in a more "normal" economic environment, the level of constraint would have been much higher.

15. **The cautious lending policy of WBG banks can be explained by various factors:**

- High level of unemployment and poverty. The Palestinians who obtain credit are generally employees of the public sector since the banks are authorized to deduct installments directly from their monthly salary.

- Political instability. Banks remember the economic downturn that occurred with the Hamas government. More generally, they remain cautious because of the potential negative economic impact that may arise from any escalation in Israeli restrictions. Therefore, banks rely essentially on collateral to extend credit rather than a mix of income analysis and collateral.

- Since most of the banks are Jordanian, they prefer to invest in markets that they know better and that they perceive as more profitable and safer. In fact, the Jordanian banks receive 65.4 percent of the deposits from and account for 35.9 percent of the loans to the WBG economy.

- Lack of moveable collateral registration.

- Lack of financial and business literacy among the public.

- Difficulty of collecting debts in default.

C. Regulation and supervision

16. **The PMA is responsible for ensuring "the soundness of banking operations, maintaining monetary stability and encouraging economic growth in Palestine, in accordance with the general policy of the National Authority".[10]** The PMA is managed by a board of directors presided by the Governor and operates independently. Although the President of the National Authority appoints all the members of the Board of Directors, there is no involvement of the Government in the PMA's administration. When enacted, the draft law on the Palestinian Central Bank would enshrine this independence.

[9] IMF estimates that private investment fell by nearly 15 percent between 2005 and 2006 (West Bank and Gaza Economic Monitoring Note – Spring 2007). The year 2006 witnessed a severe decrease in GDP (-10 percent in real terms).

[10] The mandate from the Law on the Palestinian Monetary Authority.

17. **The Banking Law is being refined.** The current law of 2002 contains the basic elements for licensing, regulation, supervision, and enforcement, but certain important matters are omitted. The law is not fully supportive of supervision in accordance with each of the Basle Core Principles; for example the current law does not provide for consolidated supervision, or relations with foreign bank supervisors. As part of the PMA development plan, a new law is being drafted that should have better articulated provisions and be more complete. The lack of provisions on corporate governance has been recently addressed with the issuance of a new regulation on bank corporate governance that also includes risk management requirements.

18. **At the regulatory level, the framework covers the main risks incurred by banks but should be updated and completed.** The PMA has adopted a set of regulations covering various key risks (liquidity, classification and provisioning, solvency, concentration of assets, diversification of banks' placements and investments, AML, operations contingency plans and foreign exchange risk). To align them with international best practices, those regulations should be updated and refined while others need to be introduced (interest rate risk and country and transfer risk[11]). There is also a need for consolidated supervision since some banks have established securities companies. A full Basel Core Principles assessment would be necessary to precisely measure the quality of the current regulatory framework and the actual degree of implementation.

19. **The PMA in 2005 launched a two-year strategic program to strengthen and upgrade the regulatory and the supervisory framework**. On the regulatory side, the PMA has drafted a new central bank law and a new banking law, which should address the weaknesses, identified above and give more independence to the PMA while requiring more transparency and accountability. The PMA has issued a corporate governance code including risk management and some other regulations are under development, in line with international best practices.

20. **As to the supervision, the PMA has adopted modern techniques to supervise banks with the assistance of the IMF**. The PMA has effective tools for assessing banks (CAEL for off-site monitoring, which is reviewed quarterly, and CAMELS for on-site examinations). The PMA uses, *inter alia*, the CAEL rating to plan its frequent on-site examinations on an annual basis but they can be conducted more frequently if the rating requires it.[12] To complete its supervisory framework, the PMA has established a macro-prudential division (July 2006). A new more detailed call report should soon be issued. Efforts should continue to further strengthen the supervisory activities of the PMA. In particular, staff needs to be hired or trained to strengthen the macro-prudential unit and inspection, notably in IT systems, which is critical to assess the efficiency of the operations contingency plan, AML systems and market risks.

21. **With regard to AML/CFT, a modern law covering financial and non-financial institutions was adopted at the end of 2007.** The Financial Follow up Unit (acting as Financial Intelligence Unit), which was set up in 2004, now reports to a National Committee composed of the main stakeholders (notably the PMA, the CMA, the Ministry of Justice, the Ministry of Interior and a legal expert). This FFU, composed of 5 persons, monitors remittances (transactions above USD 10,000 must be reported, which represents 300 transactions per day) and analyzes

[11] See the Basel Core Principles methodology (16 and 12).
[12] There are 30 examinations each year on average.

suspicious transaction reports (STRs). Since 2004, the FFU has processed very few STRs (14 of which 3 were transmitted to the Attorney General for possible prosecution). So far, only banks report to the FFU since the CMA has not enacted yet any regulation on the topic. Insurance companies, housing finance companies, financial leasing companies and securities companies should also be covered. The PMA also plans to include moneychangers, which are being licensed and regulated by the PMA.

22. **The cooperation of the PMA with other WBG regulatory agencies as well as foreign banking supervisors should be expanded**. The PMA signed a MOU with the Jordanian Central Bank in February 2008 but until recently there were no regular meetings at the operational level between supervisors and during the last 10 years only one Jordanian inspection has been carried out in WBG. The establishment of an MOU with the Central Bank of Egypt would also be appropriate since there are 8 branches of Egyptian banks in WBG. With regard to national cooperation, the PMA Governor is currently a member of the CMA board of directors, which should ensure some cooperation between both regulators. However, closer cooperation would be necessary at that stage of the WBG's financial development.

D. Market development

The PMA and some donors have undertaken a number of measures that will play a catalytic role in expanding banking services when the political situation improves

23. **The credit bureau was substantially overhauled and should now provide banks and MFIs with adequate and immediate information to aid in the assessment of the creditworthiness of their customers.**[13] The new system is completely automated and can be accessed online, free and in real-time. It contains both positive and negative information. There is no minimum value threshold so that every credit and every form of collateral (including guarantees and identification of guarantors) is reported by credit providers.[14]

24. **Although the system appears well designed, it is likely that banks will remain cautious in lending in the near term given the high level of unpredictability in the evolution of the economy.** Banks state that they will continue to rely on collateral and personal guarantees to extend credit. However, it is expected that, in the short term, the new credit bureau will help banks improve the quality of their current portfolios and reduce their NPL ratios, thereby whetting their appetite for increased lending in the medium term.

25. **The PMA has taken steps to improve the payments system.** WBG payments are currently characterized by the predominance of settlements of transactions in cash (50 percent of the total amount) followed by cheques (25 to 30 percent) and large value interbank transfers. The PMA is about to select a vendor to install a system which will provide RTGS and ACH (see

[13] As to other non-banking institutions, a MOU is being established with the CMA so that housing finance and leasing companies could contribute and have access to the database.

[14] At the time of the mission there were 270,000 credits in the database[14]. Since January 2008, the number of borrowers added to the database increased by 8.2 percent (reaching 110,000 as of May 2008), while the number of guarantors increased by 46.9 percent (47,000 as of May 2008).

section VIII). This project should have significant impact on the economy. First, it will reduce the systemic risk inherent in the current system because of deferred settlement. Second, this would provide a greater incentive for Palestinians to have bank accounts and reduce the number of transactions in cash (the future system will allow interoperability between banks so that a customer of one bank will be able to use his/her debit card in any other bank's ATM and POS). With more transactions paid by cheques, cards and transfers, the banks will have access to more financial information on their customers, enabling banks to better assess the risk profile of potential borrowers.

26. **The PMA promotes transparency, consumer literacy and protection and competition among banks.** Banking concentration in WBG, which could influence the degree of competition among incumbents, is near the average of developing countries (57.9 percent while the average is 55 percent in developing countries and 72 percent in the MENA[15]). Currently, there is robust competition concentrated on deposits. Banks organize lotteries and offer prizes to maintain and attract new deposits. However, the interest rates on saving account are low (0.5 percent per annum) and the minimum amount to open a saving account is relatively high (around 200 USD, i.e. an average of 20 percent of the GDPPC[16]). Competition on interest rates and fees is mainly for large corporates. There is no apparent competition among banks on interest rates for households and SME. Interest rates for overdrafts are between 8 and 19 percent for households and 8 to 13 percent for firms (between 8 and 12 percent for a five-year loan). Fees and commissions appear to be affordable for households and firms. The PMA instructed banks to display their terms and conditions in bank outlets. It plans to post them on its website as well as the name of banks fined for lack of transparency.[17] It would also be helpful to require banks to conspicuously provide to the public basic information of the cost of a loan: the interest rate, the total amount of interest over the life of the loan and the amount of loan installments as well as the consequences in case of default. The PMA is also active in educating Palestinians on banking activity and plans to establish curricula for schools to educate young Palestinians on banking.

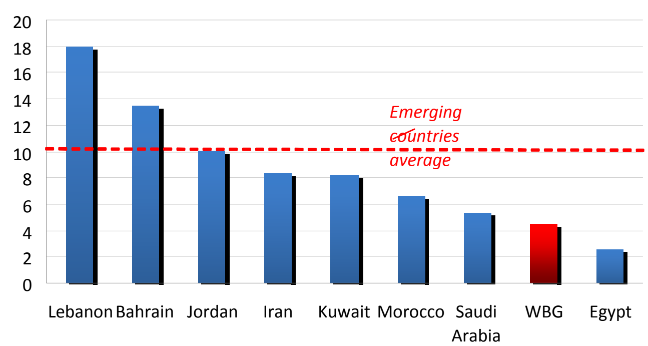
27. **Two Loan Guarantee Programs (LGPs) have begun to give access to finance to SMEs without collateral.** In WBG, the lack of collateral banks will accept is one of the major obstacles to access to credit. In the study conducted by the Palestine Economic Policy Research Institute in its report of September 2005 the five leading banks stated that between January 2000 and August 2005, 34 percent of firms did not have access to credit because of lack of acceptable collateral (70 percent for SMEs). Moreover, the ICA survey reveals that the amount of collateral requested by the banks is one of the highest in the world (157 percent of the loan – see Appendix 2). To address this issue, two loan guaranty programs for SMEs were launched in WBG (see Box 3). The EPLGP, the first program established in WBG, started its activity in October 2006. So far it has guaranteed USD 20 million of loans (1.5 percent of banks' credit to the private sector). The OPIC/PIF LGF (loan guarantee facility), which started six months ago, has provided USD 3 million of guaranties to banks for SME loans.

[15] FSDI indicator, June 2006.
[16] The worldwide average is 7 to 8 percent of the GDPPC.
[17] The PMA sanctions banks that abuse their customers (blank contracts, lack of customer duplicate).

28. **The economic situation in WBG will probably remain depressed as long as the political outlook is uncertain with the potential for severe adverse developments**. The initiatives taken by the PMA and the guarantors through the LGPs will help improve the situation but will not resolve the larger issues. However, it is critical that WBG continue to build its banking infrastructure. To strengthen this infrastructure, apart from the work underway (credit bureau, payments system) the effort should be directed toward the following goals:

29. **The increase in the number of banking outlets should continue.** Although the number of branches has steadily increased (178 branches in March 2008, which represents an increase of 25 percent over the last 7 years), WBG has only 4.5 branches for 100,000 inhabitants (3 branches for 100,000 inhabitants in Gaza), compared to a regional average of 9.2 branches (see Figure 5). This low penetration is even more problematic when considering the restrictions on mobility of people within the West Bank and Gaza. The PMA encourages the opening of new branches in WBG and requires that each new branch be equipped with an ATM.

Figure 5: Number of branches per 100,000 persons



30. **The number of currencies in use in the economy should be reduced.** In WBG, different currencies have different functions and are associated with different types of transactions. Currently, bank deposits are composed of US dollars (51 percent), Jordanian dinars (25 percent) and New Israeli Shekels (18 percent), while credit facilities are mainly in US dollars (68 percent, mainly in loans), New Israeli Shekels (20 percent, mainly in the form of overdrafts) and Jordanian dinars (11 percent). The mismatch between short and long positions in each currency for banks as well for firms and households entails costs and uncertainty. A reduction of the number of currencies, which is envisioned by the PMA, would remedy this situation. It would also create a more conducive environment for the establishment of a money market.

31. **To further develop the banking market, the policy makers in WBG should also consider assessing the following:**

- Banks report major difficulties in taking and enforcing collateral. Procedures for recovering debts secured by real estate exist but banks rarely use them since the eviction of owner-occupants is socially unacceptable. Since it is critical to prevent moral hazard from expanding, the Government should contemplate specific measures to mitigate the social impact of evictions.

- An Arbitration Law was enacted in 2000 as an alternative to protracted court procedures as well as to supplement the lack of specialized commercial courts or panels of judges but it is not widely used. An educational campaign should be established to promote the benefits of commercial arbitration that can be expected to be used by responsible parties who will accept an arbitral award and are seeking swift, competent and objective dispute resolution in financial matters.

Box 3: Loan Guarantee Programs in WBG

1- The European-Palestinian Loan Guarantee Program (EPLGP)

The EPLGP was the first guarantee fund established in WBG (it started its activity in October 2006). The European Commission, Germany through KFW and the European Investment Bank finances it. The EPLGP currently will guaranty up to USD 45 million (EUR 29 million).

This scheme aims to help creditworthy SMEs, which are unable to furnish banks with required collateral by providing banks with a guarantee that covers up to 60 percent of the value of the loan extended. Eligible borrowers must be privately-owned SMEs in operation for a minimum of two years and have less than 21 employees. They must also meet other conditions regarding underwriting practices.

Loans are currently limited to USD 50,000 while there is no minimum size. To take into account the inflation rate and the decline of the dollar and to reach a wider audience, the EPLGP envisages increasing the ceiling to USD 100,000. The EPLGP extends guaranties covering loans that finance working capital (66 percent) and investments (34 percent). The EPLGP collects a 1.5 percent annual fee based on the outstanding guarantees.

So far, the EPLGP has signed partnership agreements with six banks, all Jordanian. By end April 2008, 400 SMEs were benefiting from this program (mostly in Ramallah and Nablus), representing an amount of USD 12 million (i.e., USD 20 million in loans). So far, the EPLGP has not had any claims.

2- The OPIC/PIF loan guarantee facility (OPIC/PIF LGF)

The loan guarantee facility (LGF) was developed by OPIC and the PIF to facilitate the flow of bank credit to Palestinian SMEs, and to transform the lending culture in Palestine. The 10 year facility was officially launched in July 2007 and is administered by CHF International. LGF is designed to guarantee 70 percent of a loan extended by a participating bank to a Palestinian SME. Apart from the absence of collateral, there is no particular condition for SMEs to qualify for these guaranties. Participating banks are charged a 1.375 percent annual guarantee fee. OPIC and PIF committed to support LGF with USD 160 million, which would guarantee up to USD 230 million in loans. The program is designed to guaranty loans ranging from USD 10,000 to USD 500,000 (although the LGF can consider applications above this limit). To date, seven banks have signed on to participate in LGF, and discussions are underway with another two banks. LGF approved to guarantee 36 loans amounting to USD7.2 million as of September 30, 2008.

The wide array of loans likely to benefit from LGFs is expected to cover the vast majority of SMEs' credit needs. Indeed, according to a survey issued by the Palestine Economic Policy Research Institute in September 2006, credit needs in the form of loans over USD 10,000 would represent 88 percent of the total value of the loans needed for short terms (up to one year). This share rises to 95 percent for medium term needs (more than 5 years).

- Increase land registration well above the current 30 percent.

- Establishment of stop-loss insurance schemes. Given the political context of WBG, there is a need for a guarantee scheme designed to insure banks against possible excessive losses due to a wave of unexpected defaults by banks' customers (mainly SMEs and household mortgage finance).[18]

- Credit scoring could be developed from the Credit Bureau database. In that perspective, information from non-bank lenders (such as utility companies) may help banks further reduce their default rate. This extension of the credit bureau's network would require a modification of the legal framework.

II. THE SECURITIES MARKET

A. Providers and Products

32. **The capital market, which consists of underwriting of share issues and trading of shares on the Palestinian Stock Exchange (PSE), began 10 years ago.** There are no bond issues, no investment funds, and little share portfolio management. The CMA is responsible for the securities market and securities market intermediaries. The PSE executes all trading in shares of companies organized under the Companies Law as required by the Securities Law. Shares are dematerialized and registration of share ownership and clearing is by a department of the PSE. Settlement is T+3. The PSE has a sophisticated electronic trading system that uses the OMX platform. There is no OTC market.

33. **With 35 listed companies on the PSE, an increase from 23 in 2003, the market is thin and five companies usually account for the vast majority of the value of shares traded.** Listed companies are divided into two classes: the First Exchange, whose listing requires fulfilling certain conditions related to the company's capital (minimum subscribed capital of JOD 1 million[19]), shareholders (25 percent not owned by insiders) and financial condition; and the Second Exchange which has less stringent conditions. Listed companies are classified into five sectors: Services, Banks, Insurance, Industry and Investment. Trading is executed either in Jordanian Dinars or US dollars. Brokerage commissions are 0.7 percent and are divided between the CMA, PSE, and the broker.[20]

34. **The stock exchange is characterized by extreme volatility and relatively high share prices which could amplify economic shocks**. The aggregate value of trading value and the market capitalization have decreased since 2005. Due to political and economic disruptions, in

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[18] Stop-loss insurance is extended by some private companies (such as COFACE) for credit insurance. The COFACE sets the premium and the insured limit in excess according, *inter alia*, to an assessment of the quality of the assets to be insured (usually trade receivables).
[19] USD 1.4 million
[20] By a presidential decree on March 3, 2008, retroactively effective as of January 1, 2008, securities transactions are exempt from taxes.

2007 aggregate trading value was 38 percent less and market capitalization 56 percent less than what they were in 2005 (see Table 4). Over the past five years the most active year for trading was 2005 when average daily value of trades was USD 1.5 million, aggregate trading volume totaled USD 2 billion, and market capitalization was USD 4.5 billion. Market capitalization in April 2008 was about USD 3 billion and about one-third was attributed to shares of PalTel, the local telephone company.

Table 4: PSE Trading (2003 to 2007)

	2003	2004	2005	2006	2007
No. of trading sessions	223	244	246	238	248
Volume (million)	40.3	103.6	369.6	222.7	299.4
Daily average turnover volume (USD)	180 945	424 766	1 502 306	935 670	1 207 350
Value (million USD)	58.3	200.5	2096.2	1067.4	813.5
Daily average turnover value (USD)	261 554	821 954	8 521 050	4 484 739	3 280 117
No. of trans.	10 552	27 296	166 807	150 592	157 300
Daily average turnover trans.	47	112	678	633	634
Market Capitalization (million USD)	650.5	1 096.5	4 457.2	2 728.8	2 474.7
Market Cap. / GDP	21%	30%	109%	61%	56%
Number of listed companies	23	26	28	33	35

Source: PSE and PMA

35. **Since the market is thin and price manipulation is possible, sometimes trades are cancelled, about once a week.** The PSE has an electronic surveillance system that monitors all orders and trades to determine whether there have been violations of the trading rules. If warranted, warnings and other supervisory information are issued by the system and forwarded to the trading supervisor enabling him to halt or cancel orders or transactions in question. The surveillance system also determines the percentage increase and decline limits of a share price during trading sessions in comparison to the closing price of the previous session to enforce the limits. There is a daily price limit of five percent increase or decrease from the previous day's closing price.

36. **The capital of securities companies doubled between 2006 and 2007 due to regulatory requirements and earnings while total assets increased only 20 percent.** There are nine securities companies. These are licensed to act in one or more of the following capacities: securities brokers, securities dealers, portfolio managers, investment advisers, and securities underwriters. Securities companies guarantee trades of customers. They maintain a USD 1 million deposit with Arab Bank, the settlement bank, and this sum is proposed to be doubled. As of 2007 their aggregate total assets were USD 74.6 million and aggregate capital USD 30.4 million (see Table 5). Securities companies have about 110,000 brokerage accounts as of May 2008.

Table 5: Securities Firms' Assets and Capital

	2003	2004	2005	2006	2007
No. of licensed securities firms	6	6	7	7	9
Total assets (million USD)	7.2	13.3	75.6	62	74.6
Paid up capital (million USD)	6.9	7.3	11.6	14.6	30.4

Source: PSE

37. **Companies own approximately 47 percent of listed companies' shares while individuals 50 percent**. Table 6 indicates the classes of investors in the PSE, the percentage of their accounts and the percentage of shares owned of listed companies. PSE estimates that 10 percent of the companies can be considered institutional investors.

Table 6: Investors in PSE Listed Securities
(April 2008)

Class of Investor	Percentage of Accounts	Percentage of Shares Owned
Local individuals	94	32
Local companies	.68	20
Foreign individuals	3.29	18
Foreign companies	.31	27
Others	.33	1.7

Source: PSE

38. **Foreign ownership of shares of listed companies has increased steadily since 2005 and in May 2007 represented 45 percent.** However, many investors classified as foreign are Palestinians or Palestinian-owned companies resident abroad.

B. Regulation and supervision

39. Regulation and supervision of the issuance and trading of securities and of securities market intermediaries are governed by the Securities Law and the Capital Markets Authority Law. Both the CMA and PSE have regulatory and supervisory authority.

Securities Law

40. **The Securities Law is a complex modern law but the degree of specificity of powers and duties of securities market intermediaries is uneven.** The law contains generally appropriate provisions for the issuance and trading of securities, for disclose of business and financial information by securities issuers, and for the licensing, regulation and supervision of securities market intermediaries like securities companies, a central securities custodian, and investment funds. It prohibits exploitation of conflicts of interest by issuers' insiders and securities market intermediaries. The degree of specificity of rules is high for the securities exchange and securities depository but low for securities companies, investment advisers, investment fund trustees and investment fund managers. It would have been appropriate to

include key powers and duties for these four intermediaries. For them, more explicit rules will be found in regulations of the CMA or the securities exchange.

41. **The important matter of the allocation of responsibilities between the securities exchange and the CMA is not clear.** Article 7 provides that the exchange shall regulate and supervise exchange members, securities issuers and listed companies. Securities companies are members of the exchange. Article 28 provides for the CMA to approve securities issuances and Article 46 provides that the CMA may supervise and regulate securities companies. Article 5 provides that the CMA shall regulate the exchange. A clearer delineation of responsibility in the law would be desirable.

42. **The Securities Law should make explicit that any person who is aggrieved by a violation of the law may file a lawsuit to seek redress.** Articles 98-102 suggest that enforcement of the law will be primarily if not exclusively by the CMA. The property rights of investors should not depend upon the resources or priorities of the CMA. Other comments on remedies for violation of the securities law are in Appendix 4.

Capital Market Authority

43. **The Law of the Capital Market Authority provides generally appropriate rules for the organization, governance, funding and responsibilities of the CMA except regarding its political independence.** While Article 2 states that the CMA is an autonomous body, Article 5 provides for dominance of the board of directors by persons who are officials of other governmental authorities. The General Manager is appointed by the Council of Ministers rather than by the board as in most organizations. This governance structure raises the question of whether policies and supervisory actions may at times be taken for political reasons as distinguished from objectives inherent in the laws and regulations for promoting sound financial institutions. In addition, under Article 27 the CMA does not have the authority to issue high level regulations in implementation of its responsibilities under this law and the laws for the sectors it supervises but must propose regulations to the Council of Ministers for issuance by it. Reportedly in practice the CMA has had a high degree of operational autonomy but the composition of the governing structure should provide confidence to investors in and users of financial services that their interests would not be affected by political considerations.

44. **There are rules for disclosure by board members and senior staff of their financial interests. These are to seek to manage and prevent exploitation of conflicts of interest.** However, the rule for disclosure of the interests of family members has a narrow definition of family. The CMA’s accounts are subject to external audit.

45. **With regard to observance of key principles of securities regulation, the CMA is largely operationally independent.** It has adequate inspection, investigation, surveillance and enforcement powers. There are adequate rules for disclosure and requirements for accounting that are close to international standards. Requirements for licensing of market intermediaries are sound and capital adequacy rules are appropriate at this stage of development of the market. There are no rules for addressing failure of a market intermediary.

46. **With regard to principles for the secondary market, the PSE is subject to regulatory oversight.** There are rules to seek to ensure the integrity of trading, trade prices and volumes are transparent and there is surveillance of trading. The system of clearing and settlement of securities transactions is efficient.

47. **The CMA has delegated to the PSE primary responsibility for market conduct by securities firms.** This includes surveillance of securities trading and verifying compliance of required periodic disclosure by listed companies. CMA has its own surveillance staff and retains ultimate responsibility for supervisory matters. CMA has established cooperative arrangements including with the Jordan Securities Commission and Capital Markets Board of Turkey.

CMA regulations

48. **CMA has issued several key regulations. These include rules on issuance of securities, licensing brokers, investment and financial advisers and investment funds, capital adequacy of securities companies, and disclosure by listed companies of financial performance and material events.** Regulations on audit of companies and sanctions for breaches of the securities law and regulations are to be issued soon.

49. **There is no regulation on the suitability of investments for particular investors as there should.** Investors should be required as a condition of opening a brokerage account or for concluding a contract with an investment adviser to state their age, employment status, liquid net worth, and investment objective(s) (capital preservation, income, growth, speculation). CMA should as part of inspections of securities firms and investment advisers review the investors' preferences with actual trades and investment advice. [21]

PSE regulations

50. **PSE has issued rules including on membership on the exchange, listing requirements and disclosure by listed companies.** The disclosure requirements are consistent with best practices and include the following:

- Unaudited year-end financial statement within forty-five days from end of the fiscal year of the company
- Audited annual financial statements in the form of an annual report within three months from the end of the fiscal year of the company
- Quarterly financial statements in accordance with IAS audited by the company's auditor
- Material events that may have an impact on the company's profitability, financial position or the prices of securities issued by the company.

51. The CMA estimates that 90 percent of companies comply with the applicable rules for issuance and periodic disclosure.

[21] For example, a 70 year old person who has an objective of capital preservation should not be permitted to invest in, or be advised to invest in, an IPO to any significant extent in relation to his net worth.

C. Market development

52. **The CMA has encouraged companies to list on the PSE but given the predominance of SMEs and family-owned enterprises in the WBG economy, the potential for new listed companies is limited.** For smaller companies, there is the Second Exchange. The PSE trading platform could support a marked increase in the current trading volume but the latter is limited to low activity.

53. **Given the current situation, policy makers should consider the following to further develop the market:**

- **The securities market regulatory framework and its implementation should be refined to provide more confidence to actual and prospective investors.** The reported superficial bases for trading and vulnerability of shares to price manipulation should be addressed as should the professionalism of relations between investors, on the one hand, and brokers and investment advisers, on the other.

- **There is an acknowledged need for skilled securities analysts since much trading on the PSE is on the basis of rumors rather than on analysis of companies' fundamentals.** Brokers often advise customers to trade without a proper basis for providing advice. This is reflected in the relatively high level of prices of shares and market volatility.[22]

- **Investment funds should be promoted because at this stage of the development of the securities market, they would be the best way for individual investors to participate in the securities market**.[23] Although the index has decreased since its peak in 2005, the market capitalization remains higher than the MENA region average (around 45 percent).[24] This reflects the fact that numerous individual investors with limited financial knowledge buy shares directly on the stock exchange since there are currently no professionally managed investment funds for investment in securities.[25]

- **The PSE, which has been in the forefront in promoting market development activities, should continue to develop its investor education**. It has developed educational programs including a master's degree in finance, grants for students to support their studies and undertake research in securities subjects, and it has a simulation of securities trading on its website (www.p-s-e.com).

[22] On May 26, 2008 the market P/E was 17.47.
[23] Studies in the United States have shown that individual investors who invest on their own in individual stocks have negative returns on the whole.
[24] The market capitalization increased rapidly in 2005 and became larger than the GDP (113 percent in November 2005).
[25] There is a legal framework for investment funds (See Appendix 4).

Box 4: Legal Environment: Company Law and Creditors' Rights

The general legal regime supporting financial sector transactions is complex and incomplete or outdated in some respects.[26] *This relates to laws on companies, secured credit, and insolvency and civil procedure for enforcing contracts. Complexity results from the historical origins of the laws in WBG where Ottoman Empire, British, Jordanian and Israeli laws are operative.*

Companies are organized under either the Companies Law No. 12 of 1964 in West Bank which is the Jordanian Company Law or, in Gaza, the Companies Act of 1929 from the era of the British Mandate. Neither law, understandably, reflect the reforms in corporate governance of the past several years and a voluntary code of corporate governance is under development. A new company law has also been discussed for some twenty years and there has been a lack of agreement on whether a law that is more akin to common law or to civil law should be adopted. [27]

For example, a civil-type law is the Jordanian law that provides for a registrar of companies that, in principle, has a supervisory role regarding the rights of shareholders in individual companies while under common law it is for shareholders to enforce the law themselves. There was a hope that a new company law would be announced at the international investment conference in mid-May. A draft law was hurriedly prepared and ultimately found to be unsuitable. A four-page Presidential Decree was issued instead that contains some minor amendments to the Companies Law No. 12.

With respect to secured credit, creditors can take security interests in moveable and immoveable property but the law is wanting compared to modern laws and there is no registry for pledges of moveable property or rules for priority over conflicting claims to the same collateral. Considerable work has been done with the assistance of donors to develop a modern law but nothing has yet has been enacted.

For insolvency of companies there are provisions in the Companies Law No. 12/1964 for West Bank and in the Companies Act No. 18/1929 for Gaza. There is also a somewhat similar regime for merchants in both jurisdictions but no insolvency regime for natural persons as consumers. The laws are sufficient for liquidations of debtors' property. To effect rehabilitations, the West Bank has the Commercial Law of 1966 for composition that requires minimum payments over time periods including 75 percent of the debt in three years. It does not affect secured creditors. For Gaza there is a general provision in the Companies Act that authorizes an agreement between a company and three-fourths of its creditors to bind other creditors that may well be unfair under modern bankruptcy precepts. Thus, these laws may be insufficient to effect a reorganization and continuation of all or part of a debtor's business in complex cases.

[26] General legal regime refers to the laws other than regulatory laws for specific financial sectors.

[27] *See* Rafael La Porta *et al*., "Which Countries Give Investors the Best Protection," *Private Sector* (The World Bank Group, June 1997) at 29. This article assessed corporate governance in different countries from the point of view of protection of interests of investors—shareholders and creditors—according to the origins of commercial laws of various countries. It concluded that common law countries offered the best protection and French civil law systems the worst.

III. INSURANCE

A. Providers and products

54. **There are ten locally licensed insurance companies including two branches of Jordanian companies in WBG.** [28] USD 72 million in insurance premiums were produced in the aggregate in both 2005 and 2006; profits in 2006 of USD 5 million represented a 17 percent decrease from 2005. One company has a 25 percent share of the market and the top three companies account for 57 percent. Most insurance other than motor vehicle and medical insurance is general insurance[29] with one year policies. Minimum capital for a company that underwrites both life and non-life insurance is USD 8 million and USD 5 million for only one broad class of insurance.

55. **With respect to financial soundness, no WBG insurance company is currently rated by the three prominent insurance rating agencies and solvency and loss ratios are not currently reported to CMA.** One foreign company recently exited the market due to financial difficulties and two are troubled. One troubled company should be supported by a foreign parent and the condition of the other, which accounts for six percent of the market, is being evaluated for CMA to determine appropriate remedial action. Table 7 compares results in the insurance market in 2006 compared to 2005 in various key statistics.

Table 7: Insurance Companies Aggregate Statistics

Type of activity	2005	2006
Assets (million USD)	226	237
Investments (million USD)	120	110
Net Profits (million USD)	6	5
Technical Provisions (million USD)	112	124
Total Annual Premium (million USD)	72	72
Total Claims Paid (million USD)	33	43
Outstanding Premiums (million USD)	34	43
No of Employees	709	742
No of Policies Issued	198,000	218,000
Agents	209	150
Shareholders' Equity (million USD)	59	51

Source: CMA

56. **Motor vehicle insurance, that is obligatory, is the predominant type of insurance underwritten.** It accounted for 55 percent of the market in 2007; next is medical insurance, 13 percent. Fire, life, obligatory workers' compensation and various types of general insurance are also provided. Underwriting of life insurance has recently been declining, apparently because it is not affordable for low income persons. Table 8 provides data on the different classes of

[28] The insurance activities were very limited up to 1994. There was only one Palestinian company, which was established in 1975.

[29] General insurance means insurance for transportation, surety, etc.…

insurance underwritten. The only notable change since 2003 is a 77 percent increase in medical insurance underwritten from 2005 to 2006.

Table 8: Premia on Classes of Insurance Underwritten
(in million USD)

Classes of insurance	2003	2004	2005	2006	2007
Motor insurance	29.5	36.1	41.5	39.6	na
Marine insurance	0.7	0.8	0.9	1.0	na
Fire insurance	3.7	4.9	5.7	6.0	na
General insurances	10.0	10.9	13.9	11.4	na
Medical insurance	4.8	5.3.	5.3	9.4	na
Life insurance	4.4	4.8	4.4	4.5	na
Total production	53.1	62.7	71.7	72.0	na

Source: CMA

57. **Insurance companies do not play its role of important institutional investors.** Insurance companies' investment assets consist of real property for investment, shares negotiated on the PSE, and foreign securities and totaled USD 110 million as of end-2006. Precise statistics are not available on insurance company assets consisting of shares quoted on the PSE but it appears that insurance companies are not significant investors in the securities market. If a bond market develops they could become key investors in such debt instruments, including mortgage-backed securities, to hold long term assets to match life insurance liabilities.

58. **With respect to reinsurance, because insurance companies in WBG were unsupervised for ten years some practices[30] need improvement and they are not able to obtain reinsurance with highly rated reinsurers to the extent desirable**. Thus, currently 40 percent of reinsured polices must be with the highest category companies and this percentage will be raised to 60 percent in three years.

B. Regulation and supervision

59. **The CMA is the insurance sector regulatory authority since its creation in 2005.** It is responsible for the licensing of insurance companies, agents and brokers, developing regulations in implementation of the insurance law, and supervising compliance with the law and regulations.

60. **The Insurance Law of 2005 contains generally appropriate comprehensive provisions for licensing, regulation and supervision of the insurance market.** Regulations have been issued on licensing of companies and agents, solvency, obligatory security deposits by companies, calculation of technical reserves, reinsurance, a code of market conduct, reporting to CMA, and sanctions. The law and regulations on obligatory deposits lack specificity with regard to the quality and concentration of assets deposited. Additional comments on the insurance law are contained in Appendix 5.

[30] Notably financial, accounting and underwriting practices.

61. **Regarding key principles and practices for regulation and supervision of insurance, with respect to the supervisory system, the CMA has generally adequate powers, except with respect to issuance of regulations.** Higher level regulations must be issued by the Council of Ministers but in practice this has not been a significant impediment. The CMA insurance department is financially autonomous based on fees for licensing and from a small fraction of premia from motor insurance policies. Insurance supervision is conducted in a transparent manner including posting of regulations on the CMA website and frequent presence of inspectors in insurance companies.

62. **With respect to supervised insurance companies, agents and brokers, the licensing requirements are appropriate, transparent and public.** Boards of directors and senior management of companies are screened for probity and competence. Nine of the ten companies operating in WBG are audited by the Big Four. There are no actuaries resident in WBG but qualified actuaries are retained by companies from time to time. Corporate governance requirements for companies are rudimentary under the 1964 Companies Law No. 12 applicable in WBG but a new corporate governance code for all WBG companies is being developed as is a new company law. Companies are required to have internal audit departments that report to the boards of directors.

63. **With respect to general supervision, the CMA monitors insurance markets and reacts accordingly**. For example, CMA requires standard policies for motor vehicle insurance and workman's compensation insurance. CMA conducts off-site monitoring of companies and the market, based on quarterly reports submitted by companies. CMA conducts frequent targeted inspections of companies recently averaging about twenty visits per year to each company for 2-3 days. This frequency is based on the fact that from 1994 to 2005 companies were not subject to external supervision and developed undesirable practices. Such inspections may cover such subjects as payment of claims and relations with agents. CMA recognizes the need for enhancing financial analysis and actuarial skills of insurance company personnel.

64. **CMA takes corrective measures when necessary to insure compliance with applicable rules.** It uses a range of punitive or remedial actions such as suspending licenses, preventing writing of new business, and ordering corrective actions. It has not removed directors or managers and it does not use consensual agreements for a program of remedial measures. CMA has the authority to address severely financially distressed companies by facilitating mergers or ordering liquidation of the company but has not had occasion to use these instruments.

65. **With respect to prudential requirements, CMA requires insurers to establish adequate technical provisions for actual and potential liabilities based on companies' historical experience.** The standards for companies' investments appear rather lax regarding asset quality and diversification but CMA plans to address this deficiency. CMA has capital adequacy and solvency requirements. However, solvency ratios and loss ratios are not currently reported to CMA. Compliance with the solvency ratio is required by the end of this year.

66. **With respect to market conduct supervision, CMA has issued a code of conduct for insurers and intermediaries that is enforced.** CMA also requires prospective insurers to

receive full disclosure of terms and conditions of the insurance contract.

C. Market development

67. **The growth of the insurance market, which remains one of the less developed in the MENA area, depends mostly upon a return to normal economic activity, geographic mobility, and government authority.**[31] The contribution of insurance premia to GDP (insurance penetration) was only 1.6 percent in 2006.[32] The spending of insurance per capita (insurance density) is about USD 18 while the average is USD 60 per capita in developing economies. With the low and declining income of many of the WBG population, insurance like life insurance is a luxury they cannot afford[33]. For example, the transit restrictions result in some West Bank merchants importing through Israeli companies rather than directly. Transportation insurance for these transactions is written by Israeli insurance companies rather than by WBG companies.

68. **Recently introduced insurance products may stimulate more demand.** OPIC recently announced that it will reinsure export insurance. One company has introduced provident funds for both companies and individuals that have a modest guaranteed return with upside potential. This product is packaged with medical and life insurance. Another new product is homeowners' insurance that includes personal accident insurance and travel insurance.

69. **There is an acknowledged need for consumer education on insurance but there is currently no program in this regard.** CMA and the insurance company association should consider market development activities.

IV. PENSION FUNDS

A. Providers and products

70. **Currently, only civil servants, public employees and security personnel are covered by the Palestinian pension system which consists of several schemes administered partly by the Gaza Pension Insurance Corporation (GPIC) and partly by government ministries.** In theory, and according to the Palestinian Public Pension Law of 2005, private sector employees should also participate in the system; however, this law remains to be implemented and the system continues to operate in accordance with earlier laws and regulations. The pension schemes are all defined benefit, publicly managed and pay-as-you go financed, relying on budget transfers. GPIC's reserves have been depleted in recent years partly by court decisions freezing

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[31] With respect to government authority, in 1993 when Israel controlled automobile traffic in WBG, motor vehicle insurance premiums were twice what they were in 2006. The requirement for obligatory motor vehicle insurance was enforced in 1993. Currently many vehicles in WBG are not registered or insured.

[32] Compared to 2.7 percent in average for the emerging economies (*Source*: Swiss Re).

[33] In terms of life and non-life premia spent by the Palestinians, life insurance represent 8 percent while in developing countries, it represents 53 percent (*Source*: Swiss Re)

some of their overseas investments and by the government's failure to pay full contributions for and on behalf of its employees.

71. **Currently, there are no privately managed pension products in WBG and the domestic financial sector lacks providers which could offer pension products, other that the recently introduced insurance company product mentioned above**. Other products such as collective investment schemes are also absent and cannot be relied on to develop the pension market. There are no foreign providers present either. In general, uncertainties about political and economic prospects make pension products, which by nature are inaccessible until retirement, less appealing, especially if participation in pension schemes reduces workers' disposable income.

B. Regulation

72. **There are no regulations in place for the provision of pension products.** The underlying investment products or services (custodianship, asset management, investment advisory services, performance measurement, pension unit accounting, annuities and other payout products) are either non-existent or just beginning. The CMA was established fairly recently and is not in a position to propose regulations for pension products or to implement an effective supervisory regime.

C. Market development

73. **Due to labor market and macroeconomic conditions, it is likely that the potential pool of participants in a contributory pension system will remain limited to government employees and workers employed by a few large private corporations**. Some of the larger employers, about six private firms, are interested in private pension products and would like to contribute to private pension schemes if such schemes were available. The CMA would need technical assistance to help in the development of the necessary regulatory framework, bilateral supervisory agreements with regulators in other countries and to assist in training its personnel.

V. FINANCIAL LEASING

A. Providers and products[34]

74. **Financial leasing by companies is a relatively new activity in WBG and the array of good financed is still limited.** There are four financial leasing companies active in the market leasing motor vehicles or equipment, mainly leasing passenger cars for commercial fleets. Only

[34] This section of the report focuses on leasing of moveable property by financial leasing companies. Banks have a total of USD 10 million in assets classified as financial leases that has been stable over the past three years. These are predominantly leases of residential property in large part from Shari'a finance.

one company recently began equipment leasing, mainly office equipments. Leases of automobiles either require a personal guaranty or an initial payment of about 15-20 percent of the cost of the vehicle. Nominally financial leases have an interest rate of 7 to 11 percent that compares to commercial bank loans in the 7 to 9 percent range. However, the comparison with bank loans is difficult since leases often include maintenance and insurance. For vehicles the residual value can also be a significant source of income for the lessor.

75. **Leasing companies are the main provider of leasing transaction** (total assets represent roughly USD 40 million or 2.3 percent of the credit to private sector). They fund themselves by shareholders' equity and bank loans. Aggregate capital of the companies licensed for financial leasing is about USD 10 million, although the largest, with USD 5.6 million, is predominantly an automobile dealership. One company is a subsidiary of a public company and plans to do its own IPO to raise USD 10 million. Table 1 in Appendix 3 contains financial data on leasing companies licensed by the CMA.

76. **Given the difficulty in executing on collateral that secures a commercial loan, financial leasing, that is the functional equivalent of a loan secured by moveable property, would seem to be a viable alternative**. Yet banks have done relatively few financial leasing transactions of moveable property. One leasing company indicated that the security provided by a leased asset is not sufficient collateral for banks that usually require a multiple of the amount financed. An advantage of leasing is that if a lease contract is registered with the CMA, in the event of default, a lesser should be able to repossess leased assets in a summary proceeding.

B. Regulation

77. **The Council of Ministers and CMA have issued regulations including on licensing and registration of leasing contracts**. The IFC is currently working with the CMA to develop a law on leasing that is to include appropriate provisions in accordance with international practice. Accounting for financial leases follows IFRS No. 17 and the Ministry of Finance has issued depreciation schedules for leased assets that companies consider reasonable. There are no market conduct regulations for financial leasing other than a requirement for leasing companies to advise lessees of risk factors.

78. **There are no clear criteria in the licensing regulation for the issuance of licenses to financial leasing companies.** A regulation of April 16, 2007 contains procedures for applying for a license by a company with certain minimum capital but no explicit criteria for the grant of a license. There is also a requirement for licensed companies to apply to open branch offices that is unnecessary. Instead, if a company has the minimum required capital based on its last audited financial statement and is not currently subject to an enforcement action, it should be permitted to open branches as it deems appropriate.

Box 5: Legal Environment: Enforcement of Contract Rights

With respect to enforcing contracts including for collection of debt, the experience varies. Some MFIs regularly resort to litigation before the courts with satisfactory outcomes while some banks almost never file lawsuits to collect loans in default and rely on less formal means to collect debts, including mediation by village elders.

There are procedures for recovering debts secured by real property and unsecured debts that are efficient and useful in many countries. The Land Registration Bureau registers real property, registers security interests on real property, and assists in execution of claims secured by real property. However, dispossessing owner-occupants of residential property almost never occurs because it is socially unacceptable.

Each court of first instance has an Execution Office to which a creditor can resort when there is a default on a contract including a loan agreement. The Execution Office transmits the claim to the defendant who has seven days to contest the plaintiff's claim or pay. If the debt is not contested, the Execution Office will seize and sell assets of the defendant.

Lawsuits are used, as elsewhere, to induce a debtor to have recourse to sources of repayment like friends and family to avoid the ultimate consequence of the outcome of a lawsuit. There is imprisonment for failure to pay debts in WBG.

A promising area as an alternative to the courts is the Arbitration Law of 2000 that has been successfully used in some cases but is not widely known. It is generally consistent with modern arbitration laws except that, under Article 47, if the losing party does not voluntarily agree to comply with the arbitral award, it has to be endorsed by a court before it can be enforced. That may present an opportunity for a court to interfere when the purpose of arbitration that is to resolve disputes without involvement of courts.

C. Market development

79. **Leasing activity is expanding rapidly, at least for automobiles.** If financial leasing reaches the level in other MENA countries, this form of financing could account for 10 percent of the credit to private sector in the medium term.

80. **To maintain and accelerate this expansion, the CMA and the companies are considering the following:**

- **Developing a consumer education campaign to promote financial leasing of other than automobiles.** There are no current consumer education campaigns regarding financial leasing. As the size of the market indicates, financial leasing is a very small part of the financial sector and equipment leasing is insignificant at present. Perhaps the new financial leasing law will stimulate new investment in the sector and interest by prospective lessees.

- **The CMA would like to promote the issuance of bonds by leasing companies as an alternative to bank loans for funding**. A law on asset-backed securities is being considered. Thus, leasing companies could issue bonds secured by lease receivables and eventually such a law could support pooling and wholesale securitization of lease receivables.

VI. MICROFINANCE [35]

81. MFIs operate under similar conditions as banks described above with respect to the challenging economic environment, difficulty in creating, registering and executing on collateral, and debt collection generally.

A. Providers and products

82. **There are twelve providers of microfinance, eleven nonbanks, mainly NGOs, and one bank.** MFIs have about 60 outlets in WBG. These institutions provide loans mainly for production, consumption, and home improvements ranging from USD 200-20,000 with an average amount of about USD 1500. Loan terms are from about three months to three years and interest rates vary from about 1-2 percent per month. Some MFIs require nominal compulsory deposits from borrowers but these are not savings instruments as they almost never increase. There is no microinsurance.

83. **MFIs have managed to be resilient in the face of the marked decline in economic activity since 2000 and occasional severe disruptions on business activity**. This required in 2006 some MFIs to allow large scale moratoria or rescheduling of payments by borrowers. The MFIs financial situation improved in the past few months thanks to their efforts in debt collection and to the resuming of PA's employees salary payment. Portfolio at risk over 30 days in arrears had recorded substantial improvement, from 49 percent of the total loans in 2006 to 24 percent in 2007 (average of 4 MFIs representing 70 percent of the market). In 2008, the situation continued to improve rapidly. Available data shows that the share of loans at risk over 30 days in arrears might have decreased by 50 percent more in June 2008. Moreover, repayment rate for loans extended after the political crisis is high (around 98 percent).

84. **There is a large need for microfinance that is not being met.** According to the *Microfinance Market Survey in the West Bank and the Gaza Strip*, May 2007, there are approximately 25,000 microfinance clients and they serve perhaps only fifteen percent of the potential market.

85. **Funding for MFIs has been mainly grants from donors**. The outstanding aggregate loan portfolios of MFIs at December 2006 totaled USD 37 million. Donors have provided about USD 30 million in grant funds to MFIs since the mid-1990s. Some MFIs have received low interest loans from donors and alternative funding, including deposit-taking and equity capital is the key to future sustainability. Table 9 indicates data for the nine nonbank MFIs for which data is available.

[35] Data and some recommendations in this section of the report is from a study of microfinance in WBG commissioned by IFC and the Palestinian Network for Small and Microfinance (PNSMF), *Microfinance Market Survey in the West Bank and the Gaza Strip*, May 2007, in addition to interviews during the mission. Recommendations in the study are often identical to those of a CGAP publication, *Meeting the Demand for Microfinance in the West Bank and Gaza*, January 2006.

Table 9 : Summary of Microfinance Institutions in West Bank and Gaza[36]

Name	Legal Entity	Outstanding Portfolio USD (Dec 06)	Number of Active clients	Avg. Out. Bal. US$	Nb. of branches	Coverage West Bank	Coverage Gaza
ACAD	NGO	2,2702,389	1,381	1,957	8	N, C and S WB	All
ANERA	IP	1,102,100	591	1,865	1		All
ASALA	NGO	1,715,469	2,138	802	9	N, C and S WB	All
CHF	IP	9,592.759	4,132	2,322	8	N, C and S WB	All
FATEN	Non-Profit Company	8,294,176	4,540	1,827	15	N, C and S WB	All
PARC	Rural Cooperative	2,208,041	2,111	1,046	-	N, C and S WB	All
PDF	NGO	2,955,256	371	7,966	3	N, C and S WB	All
UNRWA MMP	UN Program	5,830,805	9,190	634	9	N, C and S WB	All
YMCA	IP	2,905,159	855	3,398	7	N, C and S WB	All
Total		**37,306,154**	**25,309**	**1,474**	**60**		

IP = Internal program / N=North / C=Central / S=South
North WB: Nablus, Jenin, Tulkarem, Qalqelia Central WB: Jerusalem, Ramallah, Jericho South WB: Bethlehem, Hebron
Source: *Microfinance Market Survey in the West Bank and the Gaza Strip*, May 2007.

86. **Alrafah Bank was established in 2006 and has an interesting business model** (see Box 6). It was able to raise USD 30 million in capital from 19,000 investors in an IPO. To be viable it plans for the first five years to have half its loans for corporate finance and half for microcredit. Its target market is about a third of the population, the tier between the two percent of the well off population served by banks and the segment served by MFIs. It currently has a loan portfolio of USD 26 million and profit in 2007 was USD 1 million, good performance for a new bank.

Box 6: Alrafah Bank's Business Model

One of Alrafah Bank's products is group lending whereby five persons borrow a multiple of their savings, from 2 to 5 times. The five are joint guarantors and also provide collateral. Loan officers handle a portfolio of 200-300 loans each and receive incentive compensation that can be up to twice their base salary.

The bank uses credit scoring based on factors including business background of borrowers, use of funds, market for borrowers' goods or services, administrative capacity, and financial condition. Credit quality thus far has been excellent with loan defaults less than 0.5 percent of the portfolio.

Alrafah Bank has established agreements with companies or programs to enhance the business prospects of its customers that strengthen customers' creditworthiness. Examples are agreements with the USAID SMART program for technical assistance to farmers and with Palestinian and Israeli marketing companies for agricultural products. It is working on provision of agricultural insurance.

[36] No data was available on two other MFIs, Caritas and Al Amin.

B. Regulation

87. **Supervision does not pose a burden on current MFI activities; however, there are no adequate requirements for governance for MFIs**. NGO MFIs are subject to the Law on Charitable Associations and Community Organizations that provides for supervision by the Ministry of Interior that has been inconspicuous.

88. **A key issue is whether, to become sustainable, MFIs will be able to engage in deposit taking and if so how MFIs would avoid excessively burdensome capital requirements or prudential regulations**. There is ample precedent in other countries for tiered regulation of deposit-taking institutions for which permissible activities depend upon the level of capital. The Basel Committee on Banking Supervision (see the Core Principle for Effective Banking Supervision regarding permissible activities) acknowledges that in some countries non-banking financial institutions that take deposits and extend credit may appropriately be regulated differently from banks, if these institutions collectively do not hold a significant proportion of deposits in a financial system. These institutions should be subject to a form of regulation commensurate to the type and size of their transactions.

89. **The PMA is developing a regulation on microfinance for both conventional lending and Shari'a finance.** The regulation will require MFIs to be organized as companies and a draft company law provides for a new category of non-profit company that some MFIs are expected to adopt. The regulation will contain requirements for governance, including for a board of directors, prudential regulations, business conduct requirements, including for disclosure of terms and conditions of loans, and external audit. It is unclear how any differences will be resolved between a code on corporate governance that is being developed for all companies and the PMA requirements for corporate governance of MFIs.

C. Market development

90. **Satisfying the unmet needs for microfinance will require a marked increase in funding on terms that are feasible for MFIs.** There is an increasing trend for international microfinance investment vehicles to offer funding to MFIs, mainly loans, and WBG institutions may get their fair share.[37] Given the uncertain political and security environment, political risk insurance for local investors like what MIGA and OPIC provide for foreign investors is being considered but it is not clear whether anything concrete will result.

91. **One problem with funding for MFIs according to some observers is that the amount of grants for individual MFIs has been too little or too much.** When too much, it is expected that funds will be disbursed too quickly that leads to distortion of pricing in the market that hinders prospects for sustainability for all MFIs.

92. **MFIs could attract more funding if there were funds to guaranty a large percentage of MFI loan portfolios similar to that available for SME loans by banks**. Some banks have

[37] *See Foreign Capital Investment in Microfinance*, CGAP Focus Note No. 44, 2008.

loan guaranties that are provided by two loan guaranty funds. There are incipient discussions for MFI loan guaranties.

93. **If MFIs were permitted to take deposits from the public or convert to banks with moderate regulatory requirements, it would enable them to become sustainable**. Moreover, profitable and expanding MFIs may encourage those institutions to meet the financial needs of the middle market (households and SMEs), therefore creating a financial continuum in the customer spectrum.

94. **Web-based MIS software was recently developed that is available to MFIs.** This should provide for better credit analysis and loan administration.

95. **The credit bureau operated by PMA is currently collecting credit information from only banks but MFIs have been offered access to the data.** This may be useful for some MFIs who lend to customers that are or were customers of banks. The bureau may collect information on MFI loans in the future. Since many prospective MFI borrowers have never had a bank loan, information on individuals' payment records towards utilities would be a useful addition to the database for MFIs.

96. **Beyond these major matters, increased professionalism by MFIs is necessary and training is being provided by various sources**. Increased financial literacy for prospective borrowers is also needed and there are programs for SMEs to be able to present bankable business plans but this does not seem to have reached micro entrepreneurs except those who are clients of MFIs through their business education activities.

VII. HOUSING FINANCE

A. Providers and products

97. **Housing needs are great in WBG, but price levels and spatial restrictions, partly due to the on-going Israeli settlement activity in the West Bank and the existence of restricted roads and areas, strongly constrain the effective demand.** Due to demographic factors and the possible inflows of returnees, some estimates suggest that the population could grow from less than 4 million to nearly 7 million people in 2020. Estimates of the needs of new housing units in the next five years vary from 40,000-50,000 per annum. Typical prices for apartments in Ramallah are around USD 100,000-200,000, or nearly 10 - 20 times the annual median income in that city of USD 850 per month.[38] Without the availability of new affordable long term mortgage finance, even the lowest price that is envisaged in PIF or Rawabi large scale developments; i.e., USD 50,000, requires a monthly income of USD 1,100 which is above the earnings of more than half of the households. Needless to say, such prices are even further out of

[38] The median household income has been found to be USD 700 per month for the whole West Bank and USD 420 in the Gaza strip. The Ministry of Housing's segmentation is as follows:

- Low income: below USD 600
- Limited income: USD 600 to 800
- Middle income: USD 800 to 1,500

reach of moderate income (below USD 800 per month) and low-income groups. However, if long-term mortgage finance becomes available, as envisaged under PIF's AMAL initiative that could significantly increase the affordability of these apartments.

98. The rental sector does not provide an alternative option for those who cannot own their home. This is in part due to the tenant protection framework, which includes rent control and makes lease renewal a right, a counterproductive combination.

99. **The banking system offers limited finance for housing and products available are little diversified.** Mortgage lending is still a new concept in WBG. It is offered by 9 banks out of 21, and the total amount of mortgage outstanding is estimated between USD 60 million and USD 120 million, or roughly 0.9 to 1.8 percent of the banks' total net assets. Most housing purchases are for cash. Remittances and direct investments by non-resident Palestinians play a significant role in residential real estate finance. Loans are essentially denominated in USD. When they are extended with PMHC's support (see below), they carry uniform conditions: 8.5 percent and maturity up to 20 years. Outside this mode, they are cheaper, 7-7.5 percent, but shorter, less than 10 years. Interest rates are generally adjustable, according to PMHC's conditions in the first case, and to the banks' internal cost of funds in the second, the actual changes being at the lender's discretion. Some lenders offer fixed rates on long maturities.

100. **Shari'a compliant housing loans are offered by the three Islamic banks, mostly in the south of the West Bank (Hebron area) and Gaza.** Volumes are probably limited, but the potential demand is said to be high, particularly among moderate or lower income groups. Developer finance is available, but not finance for rental investment probably due to rent control and the resulting very low returns in this sector.

101. **Outside the banking market, finance is provided by the Ministry of Housing which directly initiates housing construction and provides the finance required by home buyers at very concessional terms (prices limited to construction cost plus two percent interest rate).** Volumes involved have been very limited in the West Bank up to now, but the Ministry has larger scale plans (8,500 units over three years, including 2,500 in West Bank).

102. **A second tier institution, the Palestinian Mortgage and Housing Corporation (PMHC), had a catalytic effect in the emergence of mortgage lending, but its services have lost their attractiveness for primary lenders**. PMHC was created in the late '90s with the support of the World Bank Group (including IFC is a shareholder) and of the Canadian cooperation agency. PMHC provides, through two distinctly capitalized subsidiaries long-term funding to primary lenders and mortgage insurance.[39] Despite a challenging environment (it started operating in 1999, shortly before the second Intifada), PMHC contributed to the introduction of mortgages and induced banks to provide this financial service, particularly because of the risk sharing product, and helped structure the market (lending standards, capacity building, etc.).

[39] Cash flow insurance during 18 month of payment interruption, and coverage of the net loss within 70 percent of the loan balance.

103. **Over the last 3-4 years, however, PMHC experienced increasing difficulties on several fronts**. New loan production fell to a very low level (16 loans insured in 2007) and the stock of insured loans is only about 400. This situation can be explained by: the high level of liquidity of the commercial banks, which made borrowing from another source of funds unattractive; the lack of responsiveness of PMHC's conditions to the evolution of interest rates;[40] and the linkage between the two PMHC products – no insurance policy can be sold independently of a refinancing agreement, which many banks do not want. Moreover, delinquencies on the insured portfolio surged to a 35 percent peak in 2007.[41] At the end of 2007, the outstanding amount of loans insured was USD 14.9 million and the balance of refinanced loans amounted to USD 13.2 million, or 22 percent of the estimated overall mortgage lending.

B. Regulation

104. **Mortgage loans by banks and housing finance companies would be regulated by different authorities when housing finance companies are established,**. Each type is supervised and regulated by different agencies, the CMA for housing finance companies and the PMA for banks. The regulatory requirements that apply to mortgage loans for banks are in Appendix 6.

105. **The adoption by the CMA of appropriate prudential and market conduct regulations is a key element for the emergence of a sound housing finance sector.** The CMA recently started establishing a regulatory framework for this future activity. Up to now, it has adopted regulations on, *inter alia*, minimum capital (USD 5 million), loan classification, provisioning and capital adequacy (10 percent minimum ratio). Those regulations are very similar to those applicable to banks. Although it is appropriate to establish a minimum prudential and market conduct regulatory framework, excessive or inadequate regulation[42] could undermine the development of mortgage financing. Therefore, a balance will have to be struck between two goals: market development and financial stability. A pragmatic stance would be for the CMA to adopt a risk-based approach providing light and focused regulations during the maturing phase of the market, becoming more extensive when the risks of the sub-sector become more systemic in the WBG economy. Market conduct regulations should promote fair treatment of customers, consumer choice, and, through transparency, market discipline.

C. Market development

106. **The Palestinian Investment Fund (PIF) plans to help address the housing shortage in WBG by implementing a large-scale, Affordable Housing Project.** This project would target prospective home purchasers with moderate income; i.e., USD 800 – USD 1,300 per month. Through partnerships with local and international public and private sector entities, the

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[40] The refinance loans have been carrying a 5.5 percent interest rate with no change since 1999.

[41] This deterioration was largely due to the interruption of the wage payments to PNA employees in 2006/2007. The progressive resumption of payments and the large-scale loan restructuring taken by the banks resulted in a fall of the NPL rate to 12 percent in March 2008.

[42] A full range of banking-type regulation may not be appropriate for mortgage finance companies' activities.

PIF plans to lead a USD 1-1.5 billion program over five years for the construction of between 20,000 to 30,000 new houses by private developers, for part of which PIF has already acquired registered land on two sites in Ramallah and Jenin to launch the project.[43] Affordable prices will be made possible through economies of scale and possible subsidies that are expected to be embedded in the costs of infrastructure and allocated land. New infrastructure should benefit from the financial contribution of international donors, which pledged USD 7.7 billion between 2008 and 2010 to support the PA's Reform and Development Plan at the Paris Conference of December 2007. Housing is one of the key areas where investments will be supported by this collective effort to generate economic growth and private sector development.

107. **The PIF is also the driving force behind establishing a specialized mortgage lender – Affordable Mortgage and Loan Company (AMAL)**. This company will be backed by substantial financial support from OPIC, IFC, PIF and and several local banks. The goal of AMAL is primarily to help create the availability of mortgage finance for prospective home purchasers for Affordable Housing Projects. It is expected that AMAL will initially receive funding in excess of USD 500 million, from participants. AMAL is to act as a management vehicle that will assume no credit risk, and hence will have minmal capital requirements. Loan origination and servicing will be undertaken by the participating local banks. Credit risks will be borne by AMAL senior creditors (OPIC, IFC and PIF), as well as the local banks which will co-participate in the loans they originate from the programme will also benefit from the protection of a GBP 10 million (USD 17 million) first loss fund contributed by DFID.[44] This mortgage loan company offers an opportunity to stimulate finance for housing expeditiously, given the slow progress made until now in this area because of the very difficult environment. It is intended to help thousands of family access new housing stock within the next 5 to 8 years. However, existing legal, regulatory and commercial obstacles to mortgage finance which have been identified during AMAL's establishment, point to the short and medium term need for ongoing development of the housing finance system. The investors in AMAL have been prepared to assume the risks of many of these obstacles in an effort to create an operational construct in the near term. Longer term resolution of these issues will assist in facilitating a fully commercial mortgage finance market in Palestine.

108. **The strong donor support will not be sufficient to cover the financing requirements of the whole program.** The considerable investment at the national level over five years is estimated to be USD 1 billion to USD 1.2 billion in mortgages, or around 25 percent of GDP. Other large scale developments are expected in the same period, in particular a new community development of 5,000 units, called Rawabi, which is planned north of Ramallah.

109. **To further develop the market, the PA should consider the following measures:** [45]

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[43] The goal is to offer to prospective purchasers a price range substantially below the current level of private sector supply; i.e., between USD 50,000 to 120,000, significantly below the prices that currently prevail in Ramallah.

[44] A Memorandum of Understanding (MOU) among financial participants in AMAL was signed on April 14, 2008 to establish the new entity based on this modus operandi. It is expected that the operational responsibilities for managing the new institution be undertaken by the local Office of the U.S. Cooperative Housing Foundation (CHF-International).

[45] The housing finance mission was primarily to design a comprehensive technical assistance program and recommendations for housing finance are in a separate report.

- Beyond the market uncertainty due to political instability, banks place little confidence in the security brought by mortgage liens because of the weaknesses of the foreclosure process in practice, even though the process, in law, is viable. Moreover, pledging of properties seems historically to have been used by lenders as a safety net, rather than as the primary risk mitigation tool. To date, Banks explicitly avoid as a matter of policy pursuing the forced sale of residential properties because of the cultural and political implications that the repossessions entail. Lending is therefore largely based on personal guarantees (up to four co-signers can be required). Also, it is recognized that the mortgage market development is hampered by the lack of registered titles to real property and the difficulty of creating new titles. While this issue is being addressed through a program supported by the World Bank, it will be necessary to amend and consolidate laws governing mortgages.

- Improve the mortgage enforcement process and design specific measures to mitigate the social impact of evictions.

- The CMA should consider elaborating a regulatory environment more conducive to the development of instruments that helps lenders to better match housing loans with the resources to fund them.

- Consideration should be given to reform the PMHC to enable this institution to play a more active role (refinance and insurance product diversification, issuance of bonds). Attention will have to be paid to the harmonization of the prudential frameworks (CMA and PMA).

110. Given the fact that lenders require a down payment (a minimum of 20 percent is required by the CMA regulation), it would be useful to design a savings scheme dedicated to housing purposes that any lender could offer. Prudential rules would be required, and possibly an incentive by PA, for instance on the form of a grant to borrowers having met some prior savings requirements.

VIII. PAYMENTS SYSTEM

111. **Although the banking sector has rapidly grown since the signing of the Oslo Accords in 1993, the payment system in WBG remained rudimentary.** It has a number of deficiencies and vulnerabilities which are magnified by the multi-currency status of WBG as well as the movement and access restrictions resulting from the closure regime. While some banks have electronic payment instruments for their customers, WBG remains a paper-based financial transaction economy with cash being the dominant payment medium for the general public.

112. **For cheques, the PMA operates two clearing centers (one in Ramallah, one in Gaza) where they are physically presented and cleared by bank's representatives on a bilateral basis.** Since cheques can be denominated in one of the four legal currencies, the clearing centers conduct four sessions (for each currency). The final settlements by currency are processed by the

PMA through posting to the banks' current accounts on the PMA's books on a deferred net basis. These manual clearing procedures are time consuming and, moreover, sources of errors. The turn-around time for this is 4 to 5 days (5 to 6 days in Gaza). The percentage of cheques returned for lack of sufficient funds is 13 percent.[46]

113. **To settle long-term obligations such as house rental payments, mortgages, and payrolls, the banking system uses paper-based money orders**. Those orders are compiled into an electronic file which is sent every day to the clearing centers. There is no clearing mechanism concerning card payments (through ATM and POS[47]). Since there is still no interoperability between banks (customers of a bank A cannot use an ATM of a bank B). Transfers of money between banks are processed by using fax instructions. Those instructions are sent to the PMA and settled after cheques clearing sessions.

114. **Settlements between banks are carried out on a deferred basis at the end of the day for settlement of large value payments.** Then, in case of bank's inability to settle (for insufficient fund in a given currency), the PMA would arrange a loan between the defaulting bank and another bank, which has sufficient funds in the currency in question. This could pose clearly a systemic risk. Additionally, there is no formal procedure to governing this process.

115. **Aware of the weaknesses of the current system and recognizing the importance of an effective and comprehensive payments system for the development of the WBG economy, the PMA, with the assistance of the World Bank, has embarked on a modernization program.** This program is in the process of selecting the vendor in charge of the implementation of an Automated Transfer System (ATS), which will encompass a Real Time Gross Settlement system (RTGS) and an Automated Clearing House (ACH). This system will provide the WBG economy with more a flexible, cost-effective, secure payments system. The implementation phase could last 11 months. The PMA also plans to adopt a system for uniform ATM and POS transactions. This project will be conducted along with the implementation of the ATS.

116. **Systemic risk will also be reduced by the planned introduction of liquidity management functions**. These include acceptance of cash collateral in multiple currencies and mobilization of compulsory reserves to provide intra-day liquidity. The system will be able to accommodate a future Palestinian currency as well as an interbank money market.

IX. SUMMARY OF RECOMMENDATIONS

117. This section of the Report contains some forty recommendations for reforms for the subsectors reviewed and for the legal environment supporting the financial sector.

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[46] Cheques in NIS involving an Israeli national must be sent to the Israeli correspondent bank in order to be processed in an Israeli clearing center. Turn-around time in this case is significantly longer (7 days or several weeks in case of border closures) and is costly (banks charge the customer for the shipping between NIS 10 and NIS 30 shekels by cheque, i.e. USD 3 and USD 10). The PMA is discussing with the Bank of Israel to become a member of the Israeli clearance center, which would facilitate and reduce the cost of the settlements.

[47] So far only one bank has set up a POS network (1,500 terminals installed among 450 merchants).

A. Banking Sector

Recommendations	Counterpart	Priority
➢ Enact the draft banking law which provides a better basis for implementation of all of the Basel Core Principles	PMA / PA	As soon as practicable
➢ Allow all non-banking credit institutions to participate in the new credit bureau; take necessary steps to associate utility companies to the credit bureau network and build a credit rating system	PMA / CMA	As soon as practicable
➢ Conduct an assisted self-assessment of compliance with the Basel Core Principles to determine precisely the powers for and quality of supervision and regulation implementation	PMA	Short term
➢ Complete the payments system installation	PMA	Short term
➢ Require banks to provide to the public basic information on the complete cost and consequences of a loan	PMA	Short term
➢ Continue to strengthen the on site and macro-prudential supervision departments at the PMA	PMA	Short / Medium term
➢ Expand the cooperation of the PMA with the CMA as well as foreign banking supervisors	PMA / CMA / foreign banking supervisors	Short / Medium term
➢ Promote out-of-court settlement for debt collection	PMA / CMA	Short / Medium term
➢ Continue to update and complete banking sector regulations	PMA	Medium term
➢ Establish a national registry for pledges of movable property to increase the array of collateral likely to be accepted by banks to secure credit facilities	PA / PMA / CMA	Medium term

B. The Securities Market

Recommendations	Counterpart	Priority
➢ Provide for a majority of independent private sector persons on the CMA board of directors	PA / CMA	As soon as practicable
➢ Clarify in the law the allocation of supervisory and regulatory responsibilities between the PSE and the CMA	CMA / PSE	Short term
➢ Provide sole authority for CMA to issue regulations for institutions supervised by CMA	CMA	Short / Medium term
➢ Add to regulations a suitability requirement for trading for investors by brokers and for recommendations by investment advisers to investors	CMA	Short / Medium term
➢ Make explicit that investors may sue under the Securities Law to protect their property rights	CMA	Medium term
➢ Encourage organization of investment funds and the development of a bond market.	CMA	Medium term
➢ Develop the capacity of securities analysts and investment advisers	CMA	Medium term

C. Insurance Sector

Recommendations	Counterpart	Priority
➢ Issue AML/CFT regulations	CMA / FFU	Short term
➢ Strengthen companies' operations to enable them to qualify for high international ratings	CMA	Medium term
➢ Strengthen companies' operations to enable them to qualify for reinsurance of a major portion of their liabilities by highly rated reinsurance companies	CMA	Medium term
➢ Develop consumer education program	CMA	Medium term

D. Pension Funds

Recommendations	Counterpart	Priority
➢ Set up training programs for CMA personnel	CMA	Short / Medium term
➢ Develop the regulatory framework	CMA	Medium term
➢ Establish bilateral supervisory agreements with regulators in other countries	CMA	Medium term

E. Financial Leasing

Recommendations	Counterpart	Priority
➢ With the support of the IFC, enact a modern law on financial leasing (draft in preparation)	CMA	Short term
➢ Issue market conduct regulations	CMA	Short term
➢ Issue AML/CFT regulations	CMA / FFU	Short term
➢ Promote the issuance of bonds by leasing companies as an alternative to bank loans for funding	CMA	Short / Medium term
➢ Develop consumer education campaign to promote financial leasing of other than automobiles	CMA	Medium term

F. Microfinance

Recommendations	Counterpart	Priority
➢ Issue AML/CFT regulations	PMA / FFU	Short term
➢ Implement the regulation requiring MFIs to be organized as companies with effective corporate governance structures and procedures	PMA	Short term
➢ Issue market conduct regulations	PMA	Short term
➢ Allow MFIs to take deposits to enable them to become sustainable	PMA	Short / Medium term

G. Housing Finance[48]

Recommendations	Counterpart	Priority
➢ Amend and consolidate laws governing mortgages and mortgage execution	CMA / PA	As soon as practicable
➢ Design a regulatory framework more conducive to the development of instruments that helps lenders to better match housing loans with the resources to fund them.	CMA	Short term
➢ Adopt an adequate regulatory framework including market conduct regulations.	CMA	Short / Medium term
➢ Improve the mortgage enforcement process and design specific measures to mitigate the social impact of evictions	PMA / CMA / PA	Short / Medium term
➢ Design a savings scheme dedicated to eventual housing purchases that any lender could offer	CMA	Short / Medium term
➢ Reform the PMHC's secondary market business model (implement a more flexible business approach, de-link insurance and refinancing products, interest rate rules)	CMA	Medium term
➢ Restructure the insurance product of the PMHC by creating mortgage insurance on a portfolio coverage basis and stop-loss insurance to help lenders protect themselves from catastrophic or systemic events	CMA	Medium term

[48] The housing finance mission was primarily to design a comprehensive technical assistance program and recommendations for housing finance are in a separate report (<u>not all the recommendations are listed here</u>).

H. Legal Environment

Recommendations	Counterpart	Priority
➢ Adopt a modern companies law; in the interim, enact an obligatory corporate governance code.	PA	As soon as practicable
➢ Adopt a modern law for creation, registration and enforcement of security interests over property	PA	As soon as practicable
➢ Train judges in commercial and financial matters	PA	Short / Medium term
➢ Modernize case management of courts	PA	Short / Medium term

Appendix 1

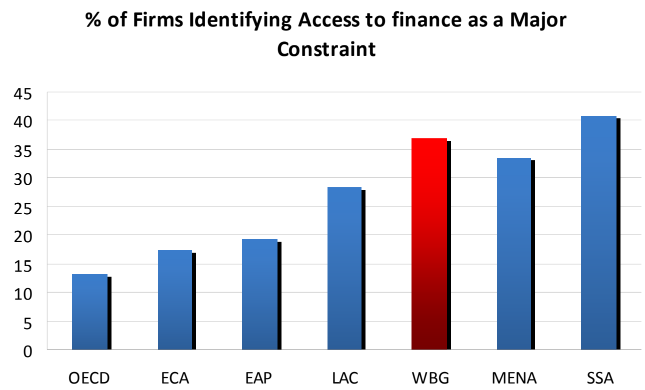
The banking sector in WBG (1/2)

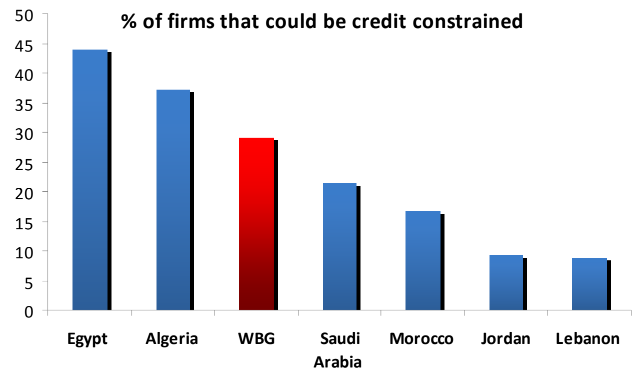
As of May 30, 2008, it was composed of 21 licensed banks. The banks amount a total of 4,114 employees and 178 branches

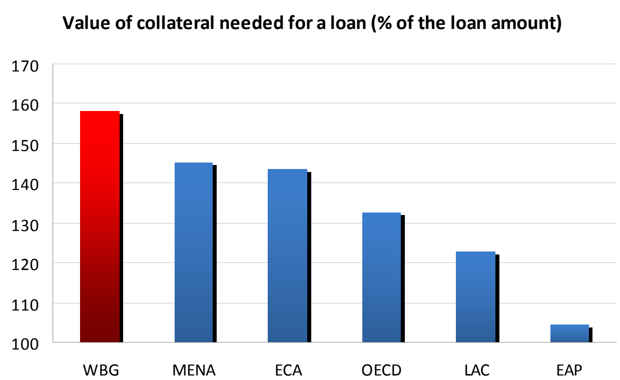
	Foreign banks	Local Banks
Commercial banks	• Arab Bank (A-) • Cairo-Amman Bank (Ba3) • Bank Of Jordan (BB-) • Jordan Commercial Bank • Jordan National Bank • Housing Bank Of Trade And Finance (Ba3) • Jordan Kuwait Bank • Union Bank for Saving and Investment • Egyptian Arab Land Bank • The Principal Bank Of Development and Agricultural Credit • HSBC Bank Middle East	• Palestine Limited Bank • Palestine Commercial Bank • Palestine Investment Bank • Alquds for Development bank • Arab Palestinian Investment Bank • Palestine International Bank • Palestinian Banking Corporation
Islamic Banks		• Arab Islamic Bank • Palestine Islamic Bank • Alaqsa Islamic Bank

Appendix 2

The banking sector in WBG (2/2)







Appendix 3

Table 1: Leasing Companies' Financial Data

Company name	Total assets in 2007			Company Profit / (loss)		Company's capital		
	NIS	JD	Equivalent in U.S.$	2006	2007	JD	Equivalent in U.S.$	US.$
The Palestinian Company for Rent & Lease (PALLEASE)	-	2,733,170.68	3,853,770.65	J.D 157,599	J.D 229161.43	-	-	100,000.00
Hundai	-	-	11,831,034.00	($749,781)	($243,895)	-	-	5,600,000.00
Good Luck Rental A Car	-	-	3,269,557.00	$35,639	$165,350	-	-	687,795.00
Al Mashriq Real Estate Co.	-	3,255,176.00	4,589,798.16	J.D 231,813	J.D (5,522)	3,256,637.00	4,591,858.17	-
Palestine Motors Co.	19,895,428.86	-	5,635,195.00	NIS 1,253,528	NIS 3,344,043	500,000.00	705,000.00	-
Sahara Co. *		-	819,256.00	$9,000	$9,128	355,000.00	497,000.00	-
United Motor Trade Co. Ltd.*	55,240,814	-	16,474,501.00	NIS 3,213,429	NIS 9,394,923	200,000.00	280,000.00	-

Note: Licensing applications for both Sahara & the United Motors are pending for Board approval.

Source: CMA

Appendix 4

Comments on the Securities Law

Investment Funds

The Securities Law does not state, as it should, the type(s) of legal entity or entities that would be investment funds. Article 52 provides that funds must have a fund manager and trustee while Articles 57 and 58 suggest that funds will also have an investment manager and a fund administrator. If funds are organized as companies, they would need a board of directors and a manager who may select asset managers, but no other investment specialists. If funds are organized as trusts there would be a trustee would serve as the fund manager and appoint asset managers but there is no trust law applicable in WBG.

Articles 55 and 57 provide for licensing of fund managers and investment managers of a fund, respectively, but this should be unnecessary since Article 40 provides that securities firms may be fund managers and investment managers.

Since the securities market is thinly traded, rules for and disclosure of asset valuation of funds' assets would be important once investment funds are established.

Remedies for violation of the Securities Law

Article 97 of the Securities Law provides that for violation of the law in connection with an initial public offering the purchase of securities may be rescinded. Instead, rescission should be a general remedy for any purchase or sale of securities in violation of the law. Article 100 contemplates rescission in circumstances other than those described in Article 97 upon the request by CMA to a court. Instead, rescission should be available at the request of any person aggrieved by violation of the securities law independently of involvement of the CMA.

Given the absence of specialized courts or panels of judges in WBG for commercial matters, consideration should be given to providing in the law or in CMA guidance that any securities exchange, securities company, investment advisor or investment fund may provide in contracts with counterparties that any dispute arising under the contract may be finally settled by *ad hoc* commercial arbitration in accordance with the Arbitration Law. Non-objective or inexpert court decisions with respect to securities litigation could discredit its legal regime and discourage investment in the market.

Appendix 5

Comments on the Insurance Law

The Insurance Law contains some anomalies. Under Article 6, basic rules on licensing, restrictions on asset composition for insurance companies, certain enforcement actions, rules on reinsurance, and market conduct rules must be issued by the Council of Ministers rather than by the CMA itself. One CMA proposed regulation has been pending for about one year.

Article 95 provides for the CMA to approve assignment of insurance policies from one company to another if CMA determines that "it does not harm the interests of policy holders." This is a difficult judgment to make and this criterion should be reconsidered since it may make CMA vulnerable in the event the assignee company does not fulfill its obligations. Article 99 should contain criteria for the CMA to approve mergers of insurance companies and Article 106 should contain criteria for the exercise of the power of the CMA to order liquidation of an insurance company.

Chapter 21, Articles 178-182, provides for penalties for violation of the law, generally fines or imprisonment. The law should add the conclusion of a written agreement between the CMA and the board of directors of an insurance company that committed infractions for a program of remedial action. Fines and imprisonment generally have only a deterrent or demonstration effect and do not address the specific problems that led to a violation.

Appendix 6

Banking Regulation on Mortgage Finance

Regulation for mortgage loans provided by banks requires that mortgage loans are weighted 70 percent for the capital adequacy ratio if secured by first liens, which is usually the case. With regard to classification (Instruction number 1/2008), depending on the time in arrears of installments, delinquent loans must be placed in the **watch list** (30 to 90 days), **substandard** (91 to 180 days), **default** (181 to 360 days) or **loss** (over one year) categories.

1. Watch list:

They are facilities where a client has failed to pay one or more installment, the interest and/or the related commission for a period of 30 to 90 days. Such facilities require special care, but no special provisions shall be necessary. In some cases, the bank must set aside “special” provisions for this class of facilities, should the borrower’s financial standing deem it necessary (if the borrower’s financial standing deteriorates, or the borrower shows signs of being in default with other banks). Outstanding interest and commissions can be recognized in the profit/loss balance within the period named above (less than 90 days). Should the borrower continue to fail to repay, interest and commissions due over the past period must be moved to the suspending interest and commissions account.

2. Substandard:

They are facilities whereby repayments have not been made in accordance with the provisions of the contract, because the debtor is facing financial and economic difficulties that are likely to impair his/her ability to serve and repay the principal, and/or interest, and/or commissions or both. This class includes facilities whereby one or more installment and/or interest and/or commissions have not been repaid for more than 90 days. Other considerations are also involved in this class of facilities, such as a court order against the client or the client being declared insolvent. In all cases, the outstanding debt shall be handled in the following manner:

1. All direct and indirect facilities extended to the debtor shall be summed up. Special provisions shall be established against the total granted facilities after deducting eligible collaterals as per the agreed ratios.

2. All outstanding and unpaid interest and commissions and/or interest and commissions paid in advance shall be suspended, and credited to the suspending interest and commissions account, until the principal is paid in full.

3. In case of restructuring (rescheduling), all suspending interest and commissions shall be earmarked to the total extended facilities , and none of them shall be recognized in the income statement.

Facilities whereby one or more installment of the principal, and/or interest and related commissions have not been repaid, or a debit checking account remains frozen for a period of 91 to 180 days, thus requiring establishment of special provisions against 20% of the total outstanding debt (direct or indirect), after deducting eligible collaterals as per the agreed ratios.

3 Default:

Facilities whereby one or more installment of the principal, and/or interest and related commissions have not been repaid, or a debit checking account remains frozen for a period of 181 to 360 days, thus requiring establishment of special provisions for 50% against the total outstanding debt (direct or indirect), after deducting eligible collaterals as per the agreed ratios.

4 Loss:

Facilities whereby one or more installment of the principal, and/or interest and related commissions have not been repaid, or a debit checking account remains frozen for more than 360 days, thus requiring establishment of special provisions for 100% against the total outstanding debt (direct or indirect), after deducting eligible collaterals as per the agreed ratios.

As to the provisioning concerning mortgage loans, for land and buildings registered at the General Registry and fully owned by the borrower, the value of the collateral is taken into following these percentages:

- 70 percent of the value for the first two years after the default date.
- 50 percent for the third year provided there is a recent valuation (less than two years).
- 35 percent for the fourth year provided there is a recent valuation, as well as making continuing efforts to collect the debt.
- 20 percent for the fifth year provided there is a recent valuation, as well as making continuing efforts to collect the debt from the borrower.
- 0 percent after the fifth year.

Properties not registered at the General Registry can also be used as collateral. In this case, the provisioning percentages are 30 percent for the first two years after the default date (instead of 70 percent), 20 percent for the third year (instead of 50 percent), 10 percent for the fourth and fifth year (instead of 35 percent). There are no other requirements in terms of the loan-to-value ratio or regular assessment of the value of the properties.