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MICROFINANCE IN CONFLICT: STRATEGIES FOR DEVELOPMENT AND PEACE IN THE ESCWA REGION

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ABSTRACT

This report tackles microfinance amidst conflict in the ESCWA region through a review of the main issues, such as the provision of microfinance services, the role of microfinance in development and the unique challenges faced by conflict-affected countries concerning microcredit and the development of financial markets. It also surveys microcredit providers in ESCWA conflict-affected countries, with an overview of the Arab World and a country level analysis of Iraq, Lebanon and Palestine. The report also analyses effective strategies for microcredit programmes amidst conflict, while focusing on the role of microfinance both in development and peacebuilding. It concludes with recommendations based on international best practice, and the experiences of different countries in the region and the world, specifically those in conflict.

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ABBREVIATIONS

ACNI	Access to Credit in Northern Governorates of Iraq
ACSI	Access to Credit Services Initiative
AMEEN	Access to Microfinance and Enhanced Enterprise Niches
ASALA	Palestinian Businesswomen's Association
CAP	Community Action Programme
CGAP	Consultative Group to Assist the Poorest
CHF	Cooperative Housing Foundation
CWEP	Center for Women's Economic Projects
ESCWA	Economic and Social Commission for Western Asia
ESFD	Economic and Social Fund for Development
GDP	Gross Domestic Product
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH
ICBG	Iraqi Company for Bank Guarantees
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IMMDF	Iraq Middle Market Development Foundation
LSC	Local Steering Committees
MDG	Millennium Development Goals
MFI	Microfinance Institution
MIS	Management Information Systems
MIX	Microfinance Information Exchange, Inc.
MSEs	Micro and Small Enterprises
NGO	Non-Governmental Organization
PAR	Portfolio at Risk
PARC	Palestinian Agricultural Relief Committees
PMA	Palestinian Monetary Authority
RSCA	Rotating Savings and Credit Associations
UNOPS	United Nations Office for Project Services
USAID	United States Agency for International Development
WWI	Women for Women International

Executive summary

This report examines the provision of microfinance services in conflict-afflicted areas in the region of the Economic and Social Commission of Western Asia (ESCWA) in particular, and offers recommendations on the best practice of microfinance during and post-conflict, specific to this region. Information in this report was compiled from secondary reports and data from different national and international institutions, think tanks and United Nations agencies as well as the Microfinance Information Exchange, Inc. (MIX) Markets database which contains detailed microfinance indicators.

The first part of the report tackles microfinance amidst conflict through a review of the main issues. It states the role of microfinance in development, and places it in the context of post-conflict and the microcredit challenges presented by these situations. As stressed by the Secretary-General in his report on "the role of microcredit and microfinance in the eradication of poverty",[1] well-targeted provision of microcredit to the poor has a direct positive impact on their lives. Indeed, it is widely recognised that countries with low income would benefit from microfinance services in order to achieve the Millennium Development Goals (MDGs). Microfinance gives access to financial services such as savings, credit, insurance and money transfer to people that otherwise would remain underserved. Target beneficiaries differ from one institution to another. While some benefit the entrepreneurial poor who can sustain themselves, others benefit the upper poor or the lower poor. Different mechanisms can assist the lower poor before they are ready for the financial services which regular microfinance institutions (MFIs) offer.

Microfinance contributes to micro and small-scale enterprises (MSE) development, which in turn is conducive to economic growth and therefore sustainable development, thus making the poor economically active in the societies to which they belong. It has been noted that only sustainable MFIs that can attract commercial sources of funds will be able to grow and serve more poor people. The ESCWA region in particular is full of experiences; both positive and negative, on how institutions, mainly MFIs, coped with harsh conditions of conflict. The constraints facing the MSE industry during conflict are mainly those that stem from instability and the political turmoil. This drives up risks and increases uncertainty which has negative effects on investments and especially on credit institutions. Compared with countries, which are not affected by conflict, those emerging from conflict face unique challenges in developing their financial markets. Post-conflict countries need institutions which can work in an initial environment characterized by a lack of security, trust and infrastructure, psychological distress of the refugees and war returnees, and high population mobility.

The second part of this report surveys microcredit providers in ESCWA conflict-affected countries. The analysis provides an overview of the Arab World and a country level analysis of Iraq, Lebanon and Palestine. Providing credit to microenterprises in these countries will develop human resources, improve the ability of the poor to generate income and thereby improve their livelihood. The microfinance industry in the ESCWA region has witnessed much progress, mainly with regards to market penetration which has increased remarkably, with the active clients almost up by five times between 1997 and 2002.[2] The sector is said to have good exposure and an understanding of good practice and regulation which are generally applied in the region. To promote the microfinance culture in the region, Governments, non-governmental organizations (NGOs) and the general public need to have more information about this sector. A further step is to encourage the participation of commercial banks in micro-lending. In addition to that, there is a need to empower women and increase their productivity, as the region has one of the lowest rates of female labour force participation. However, the main challenges in the region are the absence of stability and the increased uncertainty of ongoing and protracted conflicts.

The report proceeds to analyse effective strategies for microcredit programmes amidst conflict, while focusing on the role of microfinance in both development and peacebuilding. The report covers topics

[1] Role of microcredit and microfinance in the eradication of poverty (A/63/159).

[2] Ibid.

including essential and preferred environmental conditions, governance, institutional characteristics of MFIs, outreach, financial concerns and efficiency and productivity measures. The report also discusses how MFIs coped and should cope with default risk especially in conflict situations, and asserts that technical assistance and training needs are crucial during conflict. A discussion on donor policies and criteria is also found in this section.

The report concludes in part four with recommendations based on international best practice and the experiences of different conflict-affected countries in the region and the world.

I. MICROFINANCE IN CONFLICT: A REVIEW OF THE MAIN ISSUES

A. THE ROLE OF MICROFINANCE IN DEVELOPMENT

Microfinance is the offering of financial services to the entrepreneurial poor. Although the most notable of these services is the provision of credit, many other offerings are a part of microfinance including credit for business activities and credit for emergency and life cycle needs. Savings and deposits are also important services provided by microfinance facilities to the poor. Savings and deposits are a source of funding which is crucial for microfinance institutions (MFIs) to promote their sustainability, decrease their dependence on donor money and strengthen their resilience. While microfinance was originally conceived to target the poor, an in-depth study by the Consultative Group to Assist the Poorest (CGAP) of the client base of seven MFIs in Asia and Africa found that a large majority of microfinance clients were moderately poor (those in the top 50 per cent of households below the poverty line), few were from extremely poor households (those in the bottom 10-50 per cent below the poverty line) and none were destitute (those in the bottom 10 per cent),[3] hence reference above to the entrepreneurial poor.

The report of the United Nations Secretary-General on the role of microfinance in the eradication of poverty in 2008 clearly states that there is ample evidence that access to credit has given many poor people the means to diversify and protect their sources of income to some extent.[4] This view was reiterated by the United Nations General Assembly resolution 63/229 adopted on 10 March 2009, stating that, "microfinance, in particular microcredit programmes, has succeeded in generating productive self-employment and proved to be an effective tool in overcoming poverty and reducing the vulnerability of poor people to crisis and has led to their growing participation, in particular the participation of women, in the mainstream socio-economic and political processes of society."[5] Indeed, microfinance efforts directed towards poor women increase their incomes and savings, improve nutrition and health and increase their empowerment. This explicitly satisfies the objectives of three Millennium Development Goals (MDGs) related to poverty eradication, maternal health and women empowerment. Positive outcomes of these improvements trickle down to affect other goals.

Through microfinance, developing countries will help their local private sector to grow and sustain itself, and create wealth for people with low income. As highlighted by the United Nations Millennium Project, the recommendations related to microfinance seek to direct countries' focus towards building inclusive financial sectors that will help these countries reach the MDGs.[6]

Microfinance gives access to financial services such as savings, credit, insurance and money transfer to people that otherwise would remain underserved. These people are usually denied access to commercial loans because they do not have enough means to be able to repay.[7] Microfinance can provide financial services to this part of the population to jumpstart their productivity, help them increase their household income, and employment opportunities and consequently create demand for goods and services including education, nutrition and health.[8] This is true in the case of the entrepreneurial poor who, unlike the extremely poor, have the ability to sustain themselves but lack the means to increase their income and improve their business activities. Clearly, Microfinance Institutions (MFIs) not only raise the living standards of the poor,

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[3] Helms (2006), p. 20.

[4] Role of microcredit and microfinance in the eradication of poverty (A/63/159), p. 6.

[5] Role of microcredit and microfinance in the eradication of poverty (A/RES/63/229), p. 1.

[6] United Nations Capital Development Fund (UNCDF) (2005).

[7] Elia (2006).

[8] Brandsma and Hart (2004).

they also generate employment and eventually add to gross domestic product (GDP) growth and the economic cycle as a whole.[9]

Core principles of good microfinance include providing financial services beyond credit and savings facilities. In addition to that, services include promoting awareness towards transparency in financial accounting and transaction reporting, encouraging the exchange of clients' credit histories and improving the regulations regarding the legal form of the institutions permitting the transformation of non-regulated MFIs into specialized, regulated, or licensed rural finance and microfinance intermediaries.

Through providing access to credit and savings, MFIs help poor people take on productive activities and cross the poverty line. This explains the popularity of microfinance among donors. Nevertheless, according to the International Monetary Fund (IMF) this approach involves the risk of funds being diverted from other prominent investment areas such as education and healthcare projects.[10] For example, if a donor institution is interested in development work in a certain community, it has different options to choose from, and choosing microfinance has an opportunity cost which detracts from other community needs such as building a school or a hospital.

It is worth noting that having access to financing is not always synonymous with generating income. Nevertheless, microcredit is a crucial input in developing small enterprises. Although MFIs may attract resources which could have otherwise been used on other projects, they also utilize resources which were neglected both by the public sector and by big financial institutions.[11] Microfinance triggers the efficient use of underutilized resources in poor societies. These resources could include both labour and capital.

Only sustainable MFIs that can attract commercial sources of funds will be able to grow and serve more poor people. Profitability is seen as evidence that microfinance is a successful practice, and self-sufficiency is essential for the industry to grow without the burdens associated with donor-dependency.

After years of experience in microfinance, there is no comprehensive data on the sector. The industry has a very large number of institutions but they serve a very small number of clients and the percentage of borrowers within the potential market is still extremely low. Most activities are concentrated in a few countries where a few large institutions engage in the bulk of the transactions.[12]

B. THE CONTEXT OF CONFLICT AND POST-CONFLICT

Today, several environmental factors affect the functioning of microfinance institutions worldwide and in the ESCWA region in particular. Internal conflicts and inter-country wars have been detrimental to economic activities and have resulted in developmental losses. The region is full of experiences; both positive and negative, on how MFIs, coped with harsh conditions of conflict. Functioning in a conflict environment can be very stressful, difficult and costly. This section identifies some trends specific to conflict economies and the constraints MFIs are faced with during these specific conditions.

Conflict and post-conflict environments can be defined by three main characteristics. First in the psychosocial context, there is a loss of trust, geographic separation from families and fear of violence. Second, the economic situation is weak and distorted; there is a loss of household and business assets, lack of trust in the financial system and a small pool and high cost of skilled human resources. Third, the

[9] Brandsma and Burjorjee (2004).

[10] International Monetary Fund (IMF) (2005).

[11] Boynioughnian (2005).

[12] IMF, op. cit.

infrastructure is damaged while many have lost access to basic services such as schooling, sanitation and health care.[13]

There are microfinance trends which are specific to post-conflict situations. Most MFIs attempt product modifications and alter certain procedures for example rescheduling loans or providing new products that would be suitable for reconstruction after conflict, which can sometimes highly increase risk and cost. Post-conflict MFIs are faced with major human resource limitations as opposed to non-conflict situations where MFIs compete with the private sector to attract talented staff. In fact, limitations with regards to human resources accelerate operational costs as a result of hiring foreign staff, or training locals[14]. Security considerations also affect post-conflict MFIs by limiting operations and raising costs. These include both the staff's security as well as that of the clients. In addition, conflict environments limit the opportunities for entrepreneurship and launching of new ventures, which are highly risky and costly. These factors that are specific to conflict-affected economies impede the sustainability of MFIs at both the financial and institutional levels.

The constraints facing the micro and small enterprises industry during conflict are mainly those that stem from the instability and the political turmoil. This drives up risks and increases uncertainty, which has negative effects on investments and especially on credit institutions. Furthermore, increased operational risk can also result from parallel relief-oriented programmes, short-term oriented microfinance projects, often implemented by humanitarian organiations and political or self-interested motivations of local officials. The reason for the increase in administrative and operational costs could be attributed to rising monitoring expenses to maintain high-quality portfolio, additional security precautions, higher labour costs, additional investments in advocacy work, and training and re-training efforts.

Challenges during conflict increase MFIs overall risk especially that related to their balance sheet. Conflict also lowers the returns of investments. This is due to weakened repayment since the clients are displaced and suffer from a reduction in their productive and operational capacity. Furthermore, loan funds are decreased since deposits or lending resources are frozen or reduced, and equity values decline as a result of inflation and currency devaluations.

C. Microcredit and peacebuilding

Microfinance can be a useful tool in post-conflict recovery, both for development and for building sustainable peace. By providing access to financial services, it can restart and boost local economic development. In addition, it can play a major role in immediate post-conflict rehabilitation assistance. Beyond these economic benefits, microfinance can be highly effective as to social mobilization, empowerment, stabilization and enhancing solidarity, through social capital enhancement.[15]

One of the five core objectives to achieve peace and postconflict recovery is, as articulated by the Secretary-General in a 2009 report on peacebuilding in the aftermath of conflict, to support economic revitalisation, including employment generation and livelihoods particularly for youth and demobilized former combatants, and to rehabilitate basic infrastructure.[16] All are areas of development which benefit from microfinance.

As stated by Marino, violent conflicts mostly affect the poor because they are physically vulnerable, live in hazardous conditions, and lack strong social safety nets. The social capital of the poor is eroded as a

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[13] CGAP (2004), p. 1.

[14] Larson (2001c).

[15] Marino (2005).

[16] Report of the Secretary-General on peacebuilding in the aftermath of conflict (A/63/881), p. 6.

result of constant feelings of insecurity that come after conflict. Conflict also weakens organizations of the poor, constrains their social and physical mobility, and prolongs the vicious circle of poverty.[17]

Most importantly, studies show that microfinance encourages reconciliation and conflict resolution[18] by involving cross-ethnic cooperation; for example producers and consumers interact across ethnic borders. According to Larson, microfinance efforts smooth the transition to a normal life after conflict by developing social capital through solidarity mechanisms.[19] In addition, microfinance can encourage the reintegration of refugees, returnees and demobilized combatants, by facilitating the development of economic activities, collaboration with local populations and fulfillment of entrepreneurial spirit. Indeed, when people need to earn a living to survive, conflict becomes secondary.[20]

By empowering members to establish their own organizations, microfinance integrates democratic procedures that help people surmount conflicts. For communities divided by conflict or caste, developing credit and savings associations could be a way to bring people together, focusing on economic activities and cooperation rather than differences. Providers of microfinance services have found that group-based activities contribute to empowerment by allowing people to regain trust and confidence in each other. Groups can also discuss issues of tolerance and conflict resolution, and become catalysts in wider peacebuilding. Thus, the benefits of microfinance in post-conflict situations go well beyond economics, enhancing social capital and empowerment, and ultimately contributing to peacebuilding and reconciliation.[21]

[17] Ibid.

[18] Doyle (1998).

[19] Larson (2001a).

[20] Marino, op. cit.

[21] Marino, op. cit.

II. MICROCREDIT PROVIDERS IN ESCWA CONFLICT-AFFECTED COUNTRIES

A. OVERVIEW OF MICROCREDIT IN THE ESCWA REGION

While there is a significant lack of accurate and timely data on microcredit at the regional level, some studies show that in 2005, more than 60 active microfinance programmes were implemented in the region. Of these programs, 40 were run by non-governmental organizations (NGO) with microfinance activities lodged as part of their larger social operations. Quasigovernmental organizations including state-owned banks operating under Government oversight and serving merely as windows for credit delivery were also active.[22]

TABLE 1. NUMBER OF BORROWERS, VOLUME AND AVERAGE OF LOANS BY COUNTRY

Country	Number of participating MFIs	Number of Active Borrowers	Loan Portfolio (US$)	Average loan balance per borrower (US$)
Egypt	13	666 300	116 602 018	175.00
Jordan	6	100 206	93 595 303	934.03
Palestine	6	24 699	43 616 249	1765.91
Yemen	5	18 354	2 079 131	113.28
Lebanon	3	17 730	15 260 580	860.72
Syria	2	16 297	14 050 128	862.13
The Sudan	2	6 858	1 708 036	249.06
Iraq	1	5 268	8 341 706	1583.47

Source: MIX, 2007 Annual MFI Benchmarks.

Taken from the MIX benchmarks of 2007, the country level data on the number of firms participating in the study, number of borrowers, loan portfolio and average balance per borrower in table 1 reveals that the highest number of active borrowers is in Egypt which also has the highest loan. The highest average loan balance goes for Palestine with US$ 1765.91 per borrower. The lowest figure is in Yemen with US$ 113.28 per borrower which can be explained by the fact that Yemen (along with the Sudan) is one of the least developed countries in the ESCWA region and therefore has significantly lower living standards and GDP per capita.

The microfinance industry in the Arab region has witnessed much progress since the first microfinance survey in 1997.[23] Market penetration has increased remarkably, with the active clients up by nearly five times from 1997 to 2002. The sector has had good exposure and an increased understanding of good practice and regulations which are largely applied in the region. The industry contains a high number of fully sustainable financial institutions which are providing services to a large part of the market. According to Brandsma and Burjorjee, signs of product diversification are starting to appear in the industry as MFIs are faced with increasing competition and must become more client-oriented.[24] Some commercial banks and new MFIs have also entered the market and are transforming into single-purpose MFIs depending on their country's legal framework and the regulations that permit this kind of organizational change.

Numerous initiatives have been made in response to the need for specialized laws and regulatory frameworks regarding microfinance, which is essential to the development of the sector. These laws also

[22] Boynioughnian, op. cit.

[23] Brandsma and Burjorjee, op. cit.

[24] Ibid.

include effective regulation by the central banks of the respective countries. In addition to these initiatives, a regional network dedicated to advocacy and capacity-building for good practice microfinance is facilitating learning and exchange of know-how in the region. In many countries in the region, applying microfinance is easier today than it was ten years ago due to the massive empirical experience they underwent.

Considerable work still needs to be done to move the microfinance industry in the Arab region from the infancy stage into more maturity and consolidation. The challenges the industry faced in the past were inefficient systems and procedures, excessive donor and reporting requirements and the lack of management information systems. Today, there is a need for considerable capacity building and for product diversification, including introducing savings, leasing and insurance. Some MFIs are becoming more service oriented, offering a wider range of products while other MFIs progressively seek transformation to bypass legal constraints brought about by NGOs laws in their countries. For example, NGOs are not granted the right to hold savings. In addition to these challenges, donor dependency continues to be an issue, as only few MFIs have been successful in gaining access to commercial capital in the ESCWA region. This emphasizes the need for enhancing the regulatory framework. Programmes subsidized by the government are providing cheap credit to large numbers of people in the region, and this has a distortionary effect on the overall performance of the industry.[25]

B. MICROCREDIT IN IRAQ

Before 2003, the Iraqi banking system was dominated by two state-owned banks, the Rafidain and Rasheed. The two banks provided basic banking services and their main focus was to provide cash payments for government employees, pensioners and welfare recipients. Some small private banks were registered with the Central Bank of Iraq but these banks had few branches and provided very few services with almost no lending.

In 2003, the United States government provided grants worth US$ 30 million so that two international NGOs could develop MFIs across the country. One NGO received US$ 21 million and operated in the north. The other NGO received the remaining US$ 9 million and operated in the south. The United States Agency for International Development (USAID) contributed a further US$ 20 million in 2005 through the Izdihar project so that the microfinance industry could be further rebuilt through training and technical assistance.[26]

Demand for microfinance has continued to grow ever since. By June 2007, the total amount of loans surpassed the US$ 100 million mark of funds disbursed for the first time since microfinance activities were launched in Iraq. On the whole, MFIs operating in Iraq had “over 19,000 active clients and managed an outstanding loan portfolio of US$ 26,800,000 by mid-2007”.[27]

While the majority of loans were made to men, approximately 13 per cent of the loans were made to female clients.[28] The percentage of loans made to women was significantly lower than it was in Morocco or Egypt, countries in the region with more developed and consolidated microfinance industries. Some experiments involving women have already been implemented. Women for Women International (WWI) for example established a microfinance programme with the help of Global Giving. The programme promotes basic lending policies and practices, offers business planning training for potential clients and makes zero-interest equipment and raw materials loans to programme participants. The objective of the programme is to provide the training required for 100 women which would enable them to develop an income-generating activity. The programme focuses on the importance of solidarity: in order to join the programme, a client must form a group of three to seven women, all of whom must agree to make any missed payment of any

[25] Ibid.

[26] USAID IZDIHAR (2007), sec. 2.

[27] Howell (2007).

[28] This is not a sufficient source. ACDI/VOCA. http://www.acdivoca.org For an explanation on ACDI/VOCA see footnote 34 below.

member of the group. The perspective of WWI is that loans for equipment and raw materials constitute the best investments during the initial phases of the microfinance programme: loan recipients make regular payments to WWI for the value of the equipment or materials, which are purchased on their behalf. Business plans are assessed and approved by the programme manager and loan officers. Graduates of the programme are encouraged to develop income-generating plans using the skills they have learned. The Iraqi Widows Organization also received a grant for similar purposes. This grant provided microcredit to 120 widows to enable them to start small businesses and provide for their families. The project achieved its objective of improving the lives of these widows, with an overall success rate of 97 per cent.[29]

The Cooperative Housing Foundation (CHF)[30] began working in Iraq in June 2003 at the request of USAID. CHF has been carrying out three main projects: the Community Action Program (CAP), the Access to Credit Services Initiative (ACSI) and the Iraq Middle Market Development Foundation (IMMDF). The CAP programme directly engages Iraqi community leaders and elected local councils in restructuring essential infrastructure in their own cities and towns. This represents a holistic effort that, apart from creating new employment, serves to build a foundation for democracy. CAP I and II focused mainly on building the capacity of community action groups to fill the gap of local governments. The newest version of the programme, CAP III is based on the premise that local community needs are best met by ensuring the active participation of all stakeholders in identifying priorities and setting out courses of action.[31]

The ACSI initiative provides access to capital and financial services for low-income Iraqis. These loans are used for home improvement or to expand small-businesses. They may also be used to restock or repair equipment or to open stores. ACSI has ten branch offices in Baghdad and seven other cities in southern Iraq. Loans are compliant with Islamic principles, which prohibit taking interest when lending money.[32] As a policy goal, ACSI seeks to assist entrepreneurs in strengthening their businesses, create and sustain jobs and contribute to the economic revitalization of Southern Iraq. ACSI has become the largest microfinance programme in the country and has also become a self-sustaining local institution. ACSI has over US$ 25 million in its portfolio.[33]

The USAID-funded Izdihar project has provided technical assistance and funding to several projects. The Al-Thiqa programme was created in 2004 and has already become operationally self-sustainable, capable of covering its costs through its revenue. Since its inception, Al-Thiqa has disbursed more than 32,000 loans at over US$ 84 million. 16 per cent of its recipients are women. The institution has had an all-Iraqi management since January 2006. A similar project, Al-Takadum, is at work in the province of Al-Anbar.[34] The private non-profit organization ACDI/VOCA[35] has implemented a project called Access to Credit in Northern Governorates of Iraq (ACNI).

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[29] Information about the Iraqi Widow Organization and this project available at: http://info.worldbank.org/etools/fragilityandconflict/externalview.asp?id=318&prn=1.

[30] CHF International was originally established as the Foundation for Cooperative Housing (FCH) in 1952, a 501c(3) non-profit corporation seeking to help low- and moderate-income families in rural America and low-income urban neighborhoods to achieve improved economic standing and quality of life through the construction of affordable housing. Information on CHF International can be found at http://www.chfinternational.org/chfhistory. CHF/Iraq employs 460 locally-hired and trained Iraqis.

[31] http://www.chfinternational.org/iraq.

[32] Instead of interest, the institution charges fees on all loans up front.

[33] CHF International claims that ACSI represents approximately 80% of the microfinance market in Iraq. See http://www.chfinternational.org/iraq.

[34] Iraq Micro-Finance Industry (2009).

[35] ACDI/VOCA promotes broad-based economic growth and the development of civil society in emerging democracies and developing countries. According to its website ACDI/VOCA “fosters broad-based economic growth, raises living standards and creates vibrant communities. Its practice areas are agribusiness, food security, enterprise development, financial services and community development.” ACDI/VOCA was founded in 1963, as a 501c (3) non-profit corporation and it has 792 employees, 132 in the US and 660 overseas. It currently runs 80 projects in 42 countries. More information can be found in the website http://www.acdivoca.org

The Izdihar programme has tried to promote outreach and sustainability through the Iraq Microfinance Strategy, which includes the following strategies:

1. Promotion of awareness of microfinance and its benefits.

2. Creation and strengthening of a legal and regulatory environment that supports the establishment of new MFIs and the integration of MFIs into the financial community.

3. Capacity-building.

4. Emphasis on transparency.

5. Support of industry development through formal and informal networking opportunities.

6. Increase of business opportunities with the banking industry in order to provide MFIs with needed banking services and promote partnering arrangements between MFIs and banks.[36]

The enhancement of the legal framework, in particular, is an important component of these strategies. The key legal and regulatory issues affecting microfinance are the Central Bank of Iraq Law of 2004, the Banking Law of 2004, Coalition Provisional Authority (CPA) order No.45 and Company Law No.21 of 1997. Burdensome requirements, such as the difficulties revolving around the registration of a company that is not 100 per cent Iraqi-owned, remain under the Company Law. Difficulties also exist when registering an MFI with the NGO Assistance office or when registering a for-profit MFI with the Trade Ministry. Cumbersome reporting and registration requirements under the NGO law and Company Law and the inconsistent application of law from region to region constitute additional problems. Some suggestions for overcoming these shortcomings may be proposed. Development of the industry could be promoted with a clear mandate from the Central Bank of Iraq concerning MFIs. The sensitivity of the legal and regulatory issues affecting microfinance should also be promoted at the Central Bank and within the government. The base of products MFIs could offer should also be expanded to include savings products, equipment leasing, secured financing or real estate lending. Anti-money laundering measures, information sharing and Islamic financing could also be further developed.[37]

With respect to capacity-building (Strategy 3 of the Izdihar project under the Iraq Microfinance Strategy), brain drain to neighbouring countries has created the need to promote trainings of competent staff. Training should be conducted in MFI growth planning and strategic development, product development and marketing, financial and risk management and corporate governance.

Transparency (Strategy 4) would make the gathering of useful information possible and would serve to increase the efficiency of the industry. Outreach indicators such as gender, age or location would permit an assessment of which target groups are being served and would help generate reliable information on poverty reduction, employment generation or community stabilization. Information should be transparently collected about MFI financial and portfolio performance as well as on the expenditure of grant funds. External and internal audit capacities should also be strengthened.

The development of a microfinance network (Strategy 5) would help disseminate information about microfinance practice. Microfinance networks have the potential to be important in crisis-affected environments. They can provide remedies for deficiencies which tend to be exacerbated in crisis situations, including a lack of information, uneven application of best practice and inappropriate policy environments or uncoordinated donor intervention.

[36] USAID IZDIHAR, op. cit., Executive Summary.

[37] Elbayar (2005), pp. 11-12.

Strategy 6 proposes to strengthen the relationships between MFIs and banks in Iraq. MFIs offer products not offered by banks and conversely banks offer many products not offered by MFIs. Thus several types of linkages could be considered. The Izdihar project proposes several initiatives to increase the collaboration between banks and MFIs. These include the loan-capital financing, the partnership model between MFI and banks, the bank outsourcing model and the MFI-Bank correspondent model. The MFI-Bank correspondent model would make it possible for the Iraqi microfinance industry to consult with the Iraqi Company for Bank Guarantees (ICBG) about developing a guarantee programme that would support loan-capital financing for MFIs.

The United Nations has also been involved in microfinance activity. In 2008, a survey conducted by the International Labour Organization (ILO) and United Nations Office for Project Services (UNOPS) showed that a majority of Iraqi entrepreneurs considered limited access to credit as the major barrier to economic development. To address this shortcoming, ILO and UNOPS launched three programmes to provide micro-loans to MSEs in the Marshlands, Hillah and the rural areas of Sulaimaniyeh.[38] International NGO, CHF was selected as the implementing partner. The Local Steering Committees (LSC) were briefed about the activities under consideration and about the terms and conditions of loans disbursement and repayment procedures. The LSC provided recommendations on target districts and groups of local population to be given preferential access to loans. As a result of the programme, 960 small Iraqi entrepreneurs received average loans of US$ 1,334. Of the loan recipients, 22 per cent were women. The programme created almost 150 new jobs in economically depressed areas and the pay-back rate was 100 per cent.[39]

The average loan size in Iraq amounts to US$ 1,350, which is substantially larger than loans made in other countries. The nominal interest rate of 16 per cent is about half the global average of 35 per cent. It is quite likely that because MFIs in Iraq have higher cost structures than their counterparts in other developing countries, fees will increase in the future. A major issue for the development of the industry is that Iraqi MFIs will need to strike a balance between alienating their customer base and reaching operational and financial sustainability. The repayment rate for microloans in Iraq has been as high as 98 per cent.[40]

In terms of the legislative framework, the only requirement for MFIs in Iraq is that they are officially registered as NGOs. However some authors[41] consider that the lack of legal guidance from the Government of Iraq has likely contributed to the impressive growth of microfinance in Iraq as the general laissez-faire political environment has allowed the industry to expand and mature. Many actions have also taken place at the local level, as managers and technical advisors have been educating local officials (mayors in cities where branch offices are located) on the objectives and achievements of microfinance in Iraq. Courses have been conducted in areas such as financial analysis, accounting and auditing or risk management.

Four problems remain however for the development of this industry in what concerns the Government of Iraq. First, the registration requirement of entities as NGOs through the Ministry of Civil Society remains long and cumbersome. Second, because of the still unstable security situation many MFI offices do not want to hold cash. As a consequence MFIs hold their funds in accounts with state-owned banks in Iraq and this creates many logistical challenges (since sometimes the banks run out of cash). The lack of customer service at these banks also leads to inefficiencies: the ability to transfer funds electronically between Iraqi banks remains low, which further limits the scope of MFIs operations. Third, Government intervention through the development of a legal framework could impose excessive regulatory constraints, which may hamper the

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[38] UNDG ITF (2009), p. 6. The value of the loans was of $700,000 in the first case and $400,000 in the last two.

[39] UNDG ITF op. cit.

[40] Howell (2007).

[41] USAID IZDIHAR, op. cit., section 2.7.

growth of the industry in Iraq. Fourth, there is a need for donor diversification.[42] Finally, good governance will remain a top priority in post-conflict Iraq. Governance policies will need to be directed at encouraging entrepreneurship, balancing economic activity and enforcing market mechanisms. The most critical part of good governance with respect to MFI operations will involve the banking system.[43] It will be necessary that participants in the MFI trust the banking system.

The main problems facing the microfinance industry remain the enhancement of the legal framework, capacity-building and training, transparency, standards and reporting, the development of a microfinance network, increasing bank linkages, and the ongoing instability in Iraq.

C. MICROCREDIT IN LEBANON

Since the early 1990s, Lebanon has been in a reconstruction phase after a 15-year civil war, which paralyzed the Lebanese economy and devastated local businesses. Yet, Lebanon has succeeded in fostering one of the most advanced commercial banking sectors in the region. Over the past few years, many commercial banks in Lebanon have begun to offer microfinance products either through strategic alliance with MFIs, by developing their own microfinance products, or by offering loans to small enterprises with partial guarantees provided by specialized domestic and/or international funds. The use of formal banking services among micro and small entrepreneurs is quite high, especially in Beirut.[44]

The concepts of microfinance and microcredit were introduced to Lebanon in the mid-1990s. The microfinance sector has seen substantial growth in recent years in Lebanon, and is expected to continue to expand. Yet, the industry remains underdeveloped and suffers from lack of regulation. Measurement problems and a lack of reliable data make matters worse. Some of the only reliable and recent figures were published in a study released in 2008 by International Finance Corporation (IFC), a member of the World Bank Group and Grameen-Jameel Pan-Arab Microfinance Limited (henceforth referred to as the IFC study). According to the IFC study, Lebanon's microfinance market is relatively small (about US$ 286 million), yet only 11.5 per cent of the demand is met by existing financing sources.[45] A recent study indicated that the total supply of microcredit in Lebanon has been steadily increasing over the years, and reached approximately US$ 27 million in 2003.[46]. Despite the increasing supply, there is a large gap in the market. In order to address this gap, the microfinance industry in the country needs to build capacity, requiring an increased number of employees, staff training, and the development or improvement of Management Information Systems (MIS).

The microfinance industry in Lebanon is increasingly dominated by three institutions: Al-Quard al-Hassan Association, Access to Microfinance and Enhanced Enterprise Niches (AMEEN), and Al Majmoua. Other major players are: Association for Rural Development, Professional Mutual-Aid Association, Al-Tamkeen, Hariri Foundation, Makhzoumi Foundation, and the United Nations Relief and Works Agency for Palestine Refugees in the Near East. According to the IFC study, as of September 2007, approximately 29,420 microfinance clients were being served by NGOs, microfinance programmes, and MFIs. Together, they had an outstanding portfolio of roughly US$ 23.9 million, with an average loan size of US$ 1,118.[47].

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[42] An example could be the partnership created between an Iraqi MFI and Kiva.org, a website linking microfinance clients directly with individual lenders which allows anyone to send funds to Iraqi entrepreneurs online.

[43] Desai (2007).

[44] International Finance Corporation (IFC) and Grameen-Jameel Pan-Arab Microfinance Limited (2008).

[45] Ibid. This study is part of IFCs overall strategy to create a commercially viable microfinance sector in the Middle East and North Africa. It is also part of Grameen-Jameel's efforts to ensure that demand for microfinance services in the Arab world is met. This initiative is part of an agreement signed with Grameen-Jameel and CGAP (the Consultative Group to Assist the Poorest) in May 2007, to help the Lebanese government scale up microfinance and microenterprise development.

[46] Mattar (2007), p. 1.

[47] IFC and Grameen-Jameel Pan-Arab Microfinance Limited, op. cit.

These institutions are not licensed to accept deposits. Most Lebanese microfinance providers offer individual loans; group loans do not appear to conform to local cultural norms, as Lebanese people generally do not like sharing information or talking about financial problems.

The IFC study also shows that, as a result of the July war, about 5 per cent of business borrowers experienced direct losses, and 50 per cent of all borrowers experienced indirect losses. Various donors and multilateral development organizations provided emergency loans and other funding to Lebanese banks and small businesses following the conflict in order to rehabilitate, refinance and reschedule destroyed businesses. Though greatly affected by the war, MFIs in Lebanon provided loans to finance reconstruction efforts, and showed that they can be resilient and function properly under conflict: they were able to remain in the market, provide needed services, modify their products to meet the needs of their clients and sustain themselves.[48]

The Lebanese Government has adopted a laissez-faire attitude concerning microfinance. There are no laws concerning the microfinance industry and the Government has no clear role in the sector.[49] The only form of Government support has come from the Central Bank, which issued a directive allowing local banks to use 5 per cent of their required reserves for microfinance initiatives. However, the Central Bank of Lebanon has been unresponsive to requests to use this liquidity.[50]

Relatively recently, however, the Government has implemented two initiatives: the Economic and Social Development Fund, and "Kafalat".

(a) The Economic and Social Fund for Development (ESFD) was established in 2005 and is funded by the European Union. The ESFD stimulates the outreach of Lebanese MFIs and supports income generation, employment creation and poverty reduction. Among other activities, ESFD funds contract banks to grant loans to unbankable entrepreneurs. Loan recipients may use these funds for business start-up or development purposes. ESFD has also mobilized two microcredit funds; one is managed by non-governmental organizations and the other is managed by banks;[51]

(b) Kafalat, a financial company established by the Lebanese Government in 1999, assists small and medium sized enterprises (SMEs) in accessing commercial bank funding and debt financing. However, the establishment of Kafalat does not address the structural problems of banks and their policymakers.[52]

In terms of providing microcredit, NGOs have inherent weaknesses. They are bound by the legal provisions and restrictions applied to charities and consequently have limited access to funds since Lebanese charities are not allowed to take deposits. Their legal structure also makes it difficult to access funds from the financial sector in the form of loans. NGOs therefore depend greatly on donor funds, which translate into a lack of stability in access to credit. They also face a greater financial risk in case of default with the lack of regulations. These factors greatly contribute to their limited growth potential.[53]

The environment is made even more ambiguous by the fact that microlending is not explicitly regulated by any authoritative legal text.[54] No law has been passed by the Government in Lebanon to allow

[48] Ibid.

[49] Mamari and Ghaleb (2002).

[50] Halabi (2009).

[51] IFC and Grameen-Jameel Pan-Arab Microfinance Limited, op. cit.

[52] Mamari and Ghaleb (2002).

[53] Ibid.

[54] Ibid.

the industry to be regulated. The Ministry of Interior and Municipalities, rather than the Ministry of Finance or the Central Bank of Lebanon currently supervises all NGOs that work in the sector.[55]

Due to the high and growing poverty rate and the fact that 30 to 40 per cent of the population is unbanked, microfinance would seem like a good sector to invest in.[56] However, it remains underdeveloped. Several main factors impede growth prospects of the microfinance industry in Lebanon:

- The sector is hampered by a lack of specific legislation pertaining to microfinance, and with some exceptions, is generally inefficient;
- Donor money is in short supply due to the global economic downturn. It is therefore becoming increasingly difficult for MFIs, which depend on donations, to get money. The number of international investors has plummeted; therefore MFIs are now looking more to the local banking sector. Unfortunately, banks are not very interested in adopting microfinance programmes, mostly because such programmes require labour and management-intensive work, which means high overhead costs (5 to 8 per cent as opposed to the overhead of a normal loan which is 1.75 to 2.5 per cent).[57]
- Many organizations in the market have a political slant, for instance, the Hariri Foundation, and Al-Quard Al-Hassan, which is funded by Hizbullah. MFIs supported by political parties and/or subsidized by international institutions have lower interest rates than other MFIs, and may push the latter out of the market.[58]

D. MICROCREDIT IN PALESTINE

The constraints facing the MSE industry in Palestine could be divided into two categories; internal and external. Internal constraints can be categorized either as impediments on the entrepreneur or on the enterprise. Palestinian entrepreneurs, the young in particular, are pressured to emigrate in search of work opportunities and stability due to the ongoing occupation and ensuing deterioration of the economy in Palestine. Their mobility is severely impeded by Israeli checkpoints, which also affects their access to markets and halts their entrepreneurial spirit. These conditions curtail their employment or venture-launching activities, although a general spirit of determination and perseverance exists mainly in the youth.[59] These enterprises are characterized by a low level of organization, technology, quality of assurance and control, have little capital investment and lack capital accumulation, proper work place and space. As for the external constraints, the Palestinian MSEs suffer from the lack of finance, supporting policies, information, training programmes, increasing economic hardship and decreasing demand, the lack of proper infrastructure especially in camps (specifically electricity and transportation) and restricted access to raw materials. The sector is faced with increased competition, which has forced enterprises to decrease their prices in order to

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[55] IFC and Grameen-Jameel Pan-Arab Microfinance Limited, op. cit.

[56] Halabi, op. cit.

[57] Halawi (2009). “Harout Samuelian, vice governor of the Lebanese central bank, said one of the main challenges to the microfinance industry in Lebanon is that banks usually do not like these kinds of programs because they are very expensive. But, he added, the technologies that are available in banks nowadays make it easy for them to perform a variety of transactions in seconds. Fadi Asrawi, dean of the faculty of business administration and economics, said rapid innovations have made it possible to conduct banking operations via mobile phone and this means a real breakthrough for microfinance. "Operational costs can be as high as 15 to 20 percent of loans, compared to less than 5 percent for banks in industrialized countries. The introduction of mobile-phone banking now makes it possible to reach millions of people in the fraction of a second and without the high costs of establishing an extensive network of offices. Such cost savings are important for microfinance institutions, as they allow them to reduce interest rate margins while not impairing profitability," he added.”

[58] Halabi, op. cit.

[59] James-Wilson and Hall (2006).

maintain their competitive power. The main issue of concern to the enterprise remains political instability and occupation, which affects the overall performance.[60]

Private sector and microenterprises have played an important role in preventing absolute poverty from dominating Palestinian life.The development of this sector currently represents the most important source of employment for impovrished Palestinians, a condition which is expected to continue.[61]

Development in the microfinance industry in Palestine can be evaluated in the context of the Second Intifada, which began on September 28, 2000. The following period was characterized by intermittent clashes, invasions, closures and curfews, resulting in the widespread restriction of movement, massive destruction of personal property, lack of access to markets and severe curtailment of economic activity. While to this date, the microfinance sector has shown the ability to cope despite periods of crisis, the magnitude of the current crisis has begun to impact the capacity of institutions to sustain operations and continue to lend.[62] Many of the MFIs have reduced their levels of lending or nearly stopped making new loans.[63]

According to a 2007 IMF microfinance market survey in the West Bank and Gaza, the Palestinian microfinance sector, unlike others in the Middle East, has not been able to continue its growth in the last years; ongoing military occupation and the current political and economic crisis have prevented it from increasing its portfolio. Unlike other Arab countries where the microfinance sector has shown remarkable expansion, consolidation and evolution, microfinance in Palestine has somewhat diminished, calling into question the sector's ability to work effectively in its current form in such a difficult context[64.]

The key challenge for the Palestinian MFIs is to survive and grow in an environment lacking peace and stability. If peace is not forthcoming in the near future, MFIs may wish to consider whether credit is still an appropriate objective[65].

The Palestinian microfinance market hosts many initiatives. CHF's Ryada is considered one of the first credit programmes in the Palestinian territories. The programme has worked throughout Gaza since its inception in 1994 with support from USAID. The programme expanded in 2001 to three governorates of West Bank, added additional services in Gaza in 2003, and in 2005 expanded to three more cities in the West Bank. In 2006, Ryada experienced significant difficulties when the Palestinian Authority, whose employees were Ryada's main client base (either directly as clients or indirectly as guarantors), were no longer able to pay salaries. The portfolio at risk (PAR) over 30 days shot up to over 76 per cent. Despite this, Ryada overall continues to improve. The portfolio recorded a substantial annual growth by 66 per cent in terms of outstanding gross portfolio and 40 per cent in terms of active clients. The PAR over 30 days at the end of September 2008 was 11 per cent, down from 47 per cent at the end of September 2007, and down from 35 per cent at the end of December 2007. This trend is expected to continue. Ryada has also been able to recover 54 per cent of the written off loans as of September 2008.[66]

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[60] "Microfinance in Palestine." *Micro Finance at the University.* *http://www.saa.unito.it/meda/ppt/Micro_Finance_In_Palestine.ppt*.

[61] IFC and the Palestinian Network for Small and Micro Finance (2007), p. 18.

[62] IFC and the Palestinian Network for Small and Micro Finance, op. cit., p. 19.

[63] Ibid.

[64] Ibid.

[65] Brundsma and Burjorjee, op. cit.

[66] Available at: www.mixmarkets.org.

Another initiative within the Palestinian microfinance market is the Palestinian Agricultural Relief Committees (PARC), a union of cooperative savings and credit associations. PARC covers all licensed cooperatives in Palestine working in the field of savings and credit according to the principles and values of the cooperation. PARC aims at developing and protecting these associations by empowering and enhancing their economic and social role in achieving sustainable development in rural and urban areas. PARC services include loans and voluntary savings.[67]

Another player in the market is the Palestinian Businesswomen's Association (ASALA), which has provided loans to women since 1997 when it was first established under the name Center for Women's Economic Projects (CWEP). In January 2001, it was registered with the Palestinian Ministry of Interior as non-profit NGO and became ASALA. The main challenge facing ASALA is to work amid unstable political environment and unfair competition (best practice is not followed in other MFIs in Palestine).[68]

At present, Palestinian MFIs are not regulated as financial intermediaries by the financial authorities and they are therefore limited in the products they can offer. This includes individual and group mircolending for micro entrepreneurs, agricultural loans, Islamic loans and consumer and housing loans. Due to the regulatory environment, Palestinian MFIs may not offer saving products to the general public or services linked to remittances and payment transfers. The provision of savings products is legally restricted to institutions authorized by the Palestinian Monetary Authority (PMA), namely banks. The regulatory environment has been subject to reform since 1994. Efforts have been made to harmonize legislation regarding the Law on PMA, the Banking Law, The Law on the Capital Market Authority and the Securities Law.[69]

[67] Ibid.

[68] Ibid.

[69] Brundsma and Burjorjee, op. cit., pp. 20-21.

III. EFFECTIVE STRATEGIES FOR MICROFINANCE AMID INSTABILITY

A. CREATING AN ENABLING ENVIRONMENT FOR MICROCREDIT IN CONFLICT

Before engaging in microfinance activities, one should study the environmental propensity to absorb these financial products. This should include market research, demand studies and a comprehensive analysis of the operating environment. MFIs can only function if certain environmental conditions are met. This section enumerates these conditions and explains their prominence in making microfinance work better and more effectively. The list of conditions for a successful implementation of Microfinance in post-conflict environments is not a long one. Post-conflict microfinance can prove to be a viable choice particularly if the implementing institution is willing to face higher costs and higher risks.

The essential conditions for a post-conflict microfinance environment include three main points. Political stability is a must. Areas where the programmes are operating should offer a certain degree of security and safety to potential MFIs and their clients. The area should not be suffering from chaos, and clients need to be assured that it is both safe and profitable to take on their business activities. MFIs must feel that they are able to operate without any threats to their staff, assets and clients. Microfinance and other developmental approaches may help promote stability after conflict. Jumpstarting people's economic activity will create opportunities and reduce unemployment, hence decreasing the motivation of impoverished people to engage in conflict.[70]

Another essential condition is the presence of economic activity and the existence of demand for financial services. As mentioned in the previous sections, microfinance only works when people are already engaged in business activities. This is not always the case in environments immediately following conflict. Conflict could result in migration and population displacement. Displaced people may lose access to their physical assets or their rights to engage in economic activities. The way to deal with this is through the 'rule of thumb': if local markets are active, then the population is economically active enough to benefit from appropriate credit products.[71]

The third essential component is population stability. The key goal to any functioning MFI should be loan recovery for it to become part of the permanent fabric of an emerging post-conflict economy. This goal is hard to reach with mobile populations who may at any time abandon their loans. Thus, it proved better to work on stable populations with an increased focus on returnees rather than on refugees. The benefits derived from this include a "higher proportion of repeat customers, higher likely repayment rate, and longer period over which to spread fixed costs".[72]

In addition to the list of essential conditions, experience has shown that there are some conditions which are preferable, though not vital to the microfinance industry. The presence of these conditions definitely makes the post-conflict work easier, but their absence can be overcome. The first preferable condition is the presence of functioning commercial banks to provide MFIs with financial services to reduce costs and risks MFIs face. These services include storage of funds and electronic funds transfers. The second condition is the presence of social capital or trust. Although it is not impossible to function without it, microfinance can be impeded by distrust created by internal conflict. Finally, the presence of macroeconomic stability, including a steady currency, facilitates the business of MFIs. The key to success is not the MFIs willingness to work in high-risk and high-cost environments, but their institutional commitment to sound principles and practice of microfinance.[73]

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[70] Larson (2001c), op. cit.

[71] Ibid.

[72] Ibid.

[73] Ibid.

The development of financial institutions in conflict-affected countries is challenged by the macro-, meso and microeconomic conditions that prevail in a country immediately after a long and widespread conflict. At the national level, macro conditions affect the supply and demand for financial services. These include the lack of confidence in the economy as a result of the weak Government and the lack of security which negatively affects investments, diminished Government capital dedicated to institutional development and an increase in donor funds which are available as grants. Other macro conditions include capital flight and dollarization, a condition that results from low confidence in the local currency. This may be coupled with human flight as people look for safer and better opportunities. Destroyed infrastructure hampers growth and blocks access to the market.[74]

Meso conditions are those affecting intermediaries (namely financial intermediaries). Financial intermediaries are ineffective in mobilizing resources and raising capital through lending. Increased non-performing loans mainly to the public sector to finance the conflict render formal financial institutions dysfunctional. Semi-formal institutions, primarily NGOs, have resources to provide grants and credit and are often trusted by the community, but they have problems with the mentality of staff. These organizations usually provide humanitarian relief services, and their clients will not expect them to be tough with loan recovery. There is no strong supervisory and regulatory agency to monitor microfinance in particular.[75]

As for the micro conditions, these directly influence the demand for financial services. These conditions include the lack of confidence and trust in institutions and society, lack of productive activities and weak local labor. Endangered life, safety and diseases hinder incentives to enter long term investment contracts. Client displacement may cause difficulties in acquiring fixed assets to use as collaterals. In these conditions, women and children need particular outreach efforts.[76]

The box below reflects an experience from Bangladesh, how adverse conditions led to the establishment of Grameen Bank and how this institution actually serves the extremely poor. Clearly, this is not a golden rule to follow when choosing microfinance clients, but rather a convenient approach to ensuring the institution's survival and sustainability.

Box 1. We Serve the Poorest: Grameen Bangladesh

Responding to a devastating famine in 1974, professor Muhamad Yunus founded the Grameen Bank Project in Bangladesh aiming at providing financial services to the poor by 1976.

This segment of society has no access to institutional credit as it can not provide collateral. As such, Grameen bank followed certain principles to help change these facts. The bank only lent money to the poorest of the poor in rural areas without collateral. The activities of the bank tried to focus on women (94 per cent of its customers) and the bank granted the borrowers the right to decide the business activities for which the loans will be used for. The bank only charged interest rates to keep it self-reliant as opposed to dependant on donor funding, and used solidarity groups as one of the tools to ensure repayment.

Professor Yunus sees that development should target the bottom half of the population and specifically the bottom half of those below the poverty line. Poor people have the potential to grow and overcome poverty if given access to credit and guided to succeed. Yunus was awarded the 2006 Nobel Peace Prize, along with Grameen Bank, for their efforts to create economic and social development.

Sources: Bakhtiari (2006) *and* www.nobelprize.org.

[74] Nagarajan (1997).

[75] Ibid.

[76] Ibid.

B. INSTITUTIONAL CHARACTERISTICS OF MICROFINANCE INSTITUTIONS

All components of the financial system share the same core objectives for the regulatory framework including microfinance activities and institutions. The key principles and standards for the design of a regulatory framework for institutions providing financial services to the rural finance and microfinance sector are likely to be different from those for formal banking and finance institutions, because the design must consider the operational, market and client characteristics of the microfinance sector.

A good microfinance programme should be able to reach a large number of clients and provide financial products and services at competitive prices. This requires high operational efficiency to achieve the lowest possible transactions costs for clients. The microfinance programme must mobilize the financial and technical resources required to achieve its goals.

To perform these functions, a microfinance programme must have dedicated and competent managers, well-trained and motivated staff and internal procedures and systems that enable it to achieve self-sufficiency while providing affordable financial products. A microfinance programme constantly needs to build its institutional capacity through internal and external training, on the-job training and technical assistance. A microfinance programme learning needs evolve from basic bookkeeping, portfolio management, and loan officer training and incentives to more complicated subjects, including fraud control, internal and external auditing, financial and treasury management, diversification and accessing commercial funds. Learning needs change but never stop.

Due to the broad range of institutions, it is difficult to make general statements about the specific characteristics of MFIs. These institutions differ significantly from traditional financial institutions in terms of client features, lending technology, loan portfolio features, culture or ideology and institutional structure. MFIs can be classified into three rough categories depending on the structure of the liabilities side of their balance sheets[77].

(a) The first category includes all MFIs, which depend on other people's money to finance their lending business. Such funding is made up mainly of grants and concessionary loans from donors, which can be supplemented by commercial bank loans or securities issues. These MFIs are described as credit-only institutions and include financial NGOs. MFIs which are primarily NGOs with a welfare bias have serious problems with their governance structure. Setting up a viable MFI for the long term requires strict financial discipline. For the microfinance sector in particular, the following arguments favor regulating credit-only institutions as well: regulation can act as a "signal" to prospective investors that a financial institution is financially sound. Access to certain lines of refinance can be contingent on regulation (donor funds channeled via second-tier institutions to MFIs). Neither argument necessarily justifies Government regulation. At issue here is the self-interest of MFIs, which does not involve consumer protection or safeguarding the solvency of the financial system. Nevertheless, regulation may make sense for promoting sustainable financial institutions. In this case, its aim is to raise standards in microfinance and thus contribute to financial systems development. Particularly in countries where the microfinance industry is at a rudimentary stage, there is a danger that MFIs may abuse their monopolistic power and resort to such exploitative practice as usurious interest and improper methods of debt collection. The collapse of individual institutions can also result in credit shortages in the market;[78]

(b) In the second category, members' money is used to grant loans exclusively to members. Classic examples of this are Rotating Savings and Credit Associations (RoSCAs), savings and credit cooperatives and credit unions;

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[77] Staschen (1999).

[78] Ibid.

(c) The third category is comprised of all MFIs that use public money to finance their lending business. These MFIs are fully-fledged financial intermediaries. These do not include financial institutions that employ forced savings components to secure their lending transactions, however, as long as their clients are net borrowers. Another type is formal banks with a microfinance window. The regulations of banking legislation automatically apply to their microfinance portfolio, but these are usually poorly adapted to the requirements in this area.[79]

1. *Financial sustainability*

Financial concerns include standardized information and reporting and accountability. These concerns become more necessary in conflict environments since conflicts bring about a certain level of uncertainty and a good financial institution will be able to address these concerns to prove its resilience and ensure its sustainability. The financial performance of MFIs is evaluated based on the use of appropriate pricing policies which include offering loans at rates which cover the full costs of efficient lending on a sustainable basis. The entrepreneurial poor are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses and a minimum return on equity. Another indicator of sound financial practice is the loan portfolio quality. A loan portfolio is an MFIs most important asset. Its quality reflects the risk of loan delinquency and determines future revenues and an institution's ability to increase outreach and serve existing clients. A good quality portfolio means that an MFI is maintaining a portfolio with low arrears so that late repayments and defaults do not threaten the institution's viability.

For example, organizations with loans in arrears over 30 days below 10 per cent of loans outstanding and annual loan losses under 4 per cent of loans outstanding satisfy this condition. This is not the case if we take for instance the Palestinian Agricultural Relief Committee (PARC). PARC's estimated PAR (>30 days) is 72 per cent while the Lebanese AMEEN has a PAR (30 days) of 1.41 per cent coupled with a write off ratio of only 0.42 per cent.[80] Clearly this measurement of risk increases with the incidence of conflict.

In addition to loan quality, self-sufficiency is also a pillar to financial performance. It reduces the institutions' dependence on subsidies in order to move towards financial self-sufficiency and achieving operational efficiency. Financial self-sufficiency and operational efficiency have been achieved when all administrative costs and loan losses can be covered with client revenue within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and financial self-sufficiency within five to ten years. Examples of institutions with high sustainability rates are the Palestinian institution FATEN with an operational sustainability of 84 per cent and a financial sustainability of 72 per cent up to 2007.[81] Self-sufficiency also means that if a conflict erupts, an MFI would be able to address its own concerns quickly; not having to wait for aid or donor funds to resume its operations.

MFIs should work towards financial independence by building a solid and growing funding base with clear business plans. These plans should be backed by operational capacities that lead to mobilization of commercial funds from depositors and the financial system and eventually to full independence from donor support. Financial performance standards apply only to activities that are an integral part of providing financial services. If programmes also provide non-financial services, such as business advisory services, health, or education, they should account for such services separately from financial services.

[79] Ibid.

[80] Available at: www.mixmarkets.org.

[81] More information about FATEN available at: www.faten.org.

MFIs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. MFIs financial activities also generate various expenses, from general operating expenses and the cost of borrowing to covering losses on defaulted loans. Profitable institutions earn a positive net income (i.e., operating income exceeds total expenses).

2. *Efficiency and productivity*

Efficiency in MFIs is mainly derived from reduced costs of service delivery. According to the Consultative Group to Assist the Poorest (CGAP) definitions, efficiency and productivity indicators reflect how efficiently an MFI is using its resources, particularly its assets and personnel. MFIs use different efficiency and productivity indicators, tailoring them to reflect their own organizational structure, product lines, and monitoring priorities. In calculating these indicators, MFIs need to select which denominator they will use. The most common denominators related to assets are: (i) average gross loan portfolio; (ii) average total assets; and (iii) average performing assets, including loans, investments and other assets expected to produce income. Using average total assets as the denominator for efficiency and productivity ratios is more relevant for MFIs that manage deposit or share accounts in addition to loans. Regardless of the denominator selected, the MFI should be consistent in its use. MFIs must also decide if they wish to use the number of personnel or number of loan officers as their benchmark for human resources. The reason for considering loan officers a separate category is that, in contrast to other personnel, they are usually directly involved in revenue-generating tasks that result in income because they make and collect loans. However, there is a trend towards using total personnel in productivity calculations, in recognition of the fact that loan-officer tasks may overlap with the tasks of administrative staff.

The efficiency variable ‘cost per borrower’ represents the average cost of maintaining an active borrower or client. It is useful to compare GDP per capita with an MFIs efficiency in the local context. Because they count clients rather than amounts, these indicators have the advantage of not prejudicing MFIs which offer smaller loans. When analyzing costs per borrower, the highest numbers go to the Iraqi MFI Al-Thiqa, with US$ 298 while the lowest go to the Palestinian PARC with US$ 19 signifying high efficiency levels. The quality of PARC’s portfolio is bad though, with 72 per cent PAR (>30 days).

A comparative analysis of the Palestinian PARC and the Iraqi Al-Thiqa is provided in Table 3 below. The table compares the two MFIs, ranking them based on their performance in the variable ‘cost per borrower’. Other variables included are ‘borrowers per staff member’, ‘assets’ and ‘deposits’. Clearly, the borrowers per staff in Al-Thiqa are more than twice those of PARC: 122 to 53, which either signifies higher productivity in Al-Thiqa employees or a shortage in staff in PARC. Al-Thiqa’s assets are roughly US$ 9 million which is more than triple those of PARC (roughly US$ 3 million), but it is evident that Al-Thiqa does not have any deposits. If we compare them to our sample of 15 MFIs from 5 different countries, PARC performs a lot better than average US$ 19 to US$ 131.79, while Al Thiqa’s, assets outperform PARC and the average US$ 9 to US$ 4 million.[82]

TABLE 2. COMPARATIVE ANALYSIS OF PERFORMERS

	MFI	Cost per Borrower*	Borrowers per staff member	Assets*	Deposits*
Best Performer◦	PARC- Palestine	19	53	3 005 012	546 714
Worst Performer◦	Al-Thiqa- Iraq	298	122	9 119 030	0
Average in Sample	15 MFIs	131.79	96.33	4 027 423.13	71 573.16

Source: MIX Markets Database- Sample includes MFIs from Iraq, Lebanon, Palestine, The Sudan and Yemen.

* *Costs, Assets and Deposits in US$.*

◦ *Best and worst performances based on the first variable; cost per borrower.*

[82] Available at: www.mixmarkets.org.

Another variable measuring efficiency is operating expenses which includes all administrative and personnel expenses. Analysts must be careful when comparing this ratio between MFIs since those institutions that provide smaller loans will compare unfavourably to others, even though they may be serving their target market efficiently. Also, MFIs that offer savings and other services will also compare unfavourably to those that do not offer these services. Analyzing operating expenses suggests that the Yemeni Aden is the least efficient with 40.83 per cent operating expenses/assets and 62.32 per cent operating expense/loan portfolio while the Palestinian PARC, validating the previous conclusion, has 1.44 per cent and 1.86 per cent respectively.[83]

Productivity is a combination of outreach and efficiency. Productive MFIs maximize services while using the least resources, including staff and funds. Although different MFIs offer differentiated products, the productivity measures of different Arab MFIs can be analysed. With regards to staff productivity, the variable 'borrowers per staff member' suggests that the Yemeni Aden is the least productive with a figure of 26. The total number of personnel and the number of active borrowers are 77 and 1,967 respectively, which signifies a high number of staff for a small number of clients conversely; the borrowers per staff member are 200 at the Sudanese PASED. They have 21 staff members and 4,200 active borrowers. This signifies a high level of productivity within the institution.

On efficiency grounds, microfinance may provide an alternative to alleviate frictions in financial markets. It is widely recognized that financial markets are especially vulnerable to failures resulting from information asymmetries between the parties involved in financial contracts. As a result, financial markets may fall short of the socially-optimal outcome, failing to facilitate otherwise efficient transactions. Such problems are exacerbated in developing countries, and disproportionately affect the poor since their lack of collateral worsens the effects of information asymmetries. By developing new lending and saving technologies, MFIs may help alleviate these market failures and increase the reach of financial services to the poor. Efficiency arguments imply that the private sector has an incentive to develop commercially-viable microfinance activities, but this has proven to be a challenge. To the extent that microfinance activities provide a way to circumvent imperfections in financial markets, they have the potential to become self-sustainable.

At the same time, if MFIs have a technological or informational advantage over traditional financial institutions, they should have been able to obtain access to private funding, perhaps including through various forms of cooperation or vertical integration within the financial system. In fact, enhanced cooperation between existing financial institutions and MFIs could contribute to the development of local financial markets. However, most of the external funding to the microfinance industry comes from donor sources, and the integration of MFIs with traditional financial institutions is not widespread.

3. *Coping strategies and risk*

MFIs are faced with various forms of risks. Clearly, these risks, which are present even under non-conflict conditions, are higher and more detrimental in conflict environments. Credit risk is the danger that a borrower is not capable of or not willing to repay the interest or principle of a loan. Credit risk is particularly volatile, as collateral substitutes depend a great deal on confidence, there is a heavy sectoral and geographic concentration of loans and the portfolio turnover rate is higher. The large-scale credit risk is usually low because micro loans are granted.

Another risk is associated with interest rates. Fixed-interest terms in lending and deposit businesses can be problematic when the commercial interest rate changes. This risk is particularly great when rising commercial interest rates deposits cannot be offset because of interest caps in lending business. This is more often the case with MFIs due to their higher interest rates.

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[83] Ibid.

Liquidity risk is the risk of a temporary cash flow problem. Assets can only be liquidated by taking large losses. This is likely for many MFIs due to poor liquidity management and lack of access to liquidity pools or a lender of last resort. This has huge effects on credit risk as access to subsequent loans is often the major repayment incentive.

Management risk is the risk of portfolio deterioration due to management defects. Failures of management may be inadvertent, brought on by insufficient skills or they may be wilful, in the case of opportunistic behaviour of fraud. The success of an MFI is particularly dependent on the qualification and the proper conduct of management and staff.

New industry risk is the risk of trying out new and innovative finance technologies. This risk is relatively high for new products, technologies, markets and institutional design. Ownership and governance risks stem from the fact that an MFIs solvency is dependent on ownership relations and governance structure. This is important due to the frequent lack of external regulation and supervision. Risks can be very high for NGOs and cooperatives. Subsidy dependence risk is the risk of dependence on subsidy donors and a sudden stoppage in subsidies.

One of the most pressing kinds of risk that can impede the healthy functioning of an MFI is default risk, and coping with it has been the target of all financial institutions in general and MFIs in particular. Thus, NGOs and other MFIs should be very cautious in offering credit because they cannot take a chance on non-payments, late payments, complete defaults or other risks.[84] Microcredit advocates need to see the contradiction between doing everything to build peace (helping returning combatants) and economic development.

Programmes could do so through giving individual loans to microentrepreneurs who have qualified guarantors in case of default. It is also notable that healthier clients mean stronger MFIs, and over time, reduced poverty. They can ultimately lead to reduced portfolio losses because fewer clients may be absent or drop out due to illness, or default due to death. Thus, insurance policies may offer emergency loan collateral, as in the case of fires or droughts. Compulsory savings could be required from all microentrepreneurs so that even in adverse circumstances, defaulting on one's microloan may be prevented, especially if the amount of savings is significant. Thus, the entrepreneurial poor would have their own resources to fall back on. This would protect the MFIs portfolio.[85]

Built-in loan flexibility is another option for coping with difficult settings especially in conflict situations. This might take the pressure off clients who, because of a crisis, do not want to move up to the next cycle of a larger loan, with its resulting pressures. Instead, one could take a rest or a break, and then re-enter the microcredit system when feeling ready, without pressure to take on loans one may not be able to afford. New insurance tools may be designed and implemented by the MFI, as mentioned earlier: life insurance, health insurance, credit insurance, funeral insurance, and so on. This is mutually beneficial for both the borrowers and the institutions.

As in the case with other adverse environments like droughts for example, conflict situations need specific measures and efforts on behalf of MFIs. These efforts include tracking the problem evolution, the number of client dropouts, evaluating client performance and changes, conducting exit interviews and tracking arrears and defaults. All these steps may lead to decreasing the impact of conflict and to more consistent measures that would make the MFI more sustainable and more resilient against future shocks.[86] These activities need good risk management as well as efficiency in operation on behalf of MFIs.

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[84] Doyle (1998).

[85] Woodworth.

[86] Ibid.

Another factor is the need to consider the greater costs of MFI work in post-conflict situations items such as increased security, steeper travel costs and higher compensation for staff. It is important to partner with other NGOs or Government agencies that can give the MFI insight and the benefits of experience. This may save time and money, as well as help to avoid pitfalls after the conflict has subsided so that potential borrowers do not mistakenly conclude that microcredit is just one more handout. Good MFI practice is even more essential in times of war than in times of peace.

MFIs should charge market rate interests, build a highly-skilled staff with multiple organizational efficiencies, work towards becoming sustainable, and operate superb portfolio quality. The institution will not succeed if it is confused with post-war humanitarian aid. Portfolio risks need to be assessed and strategically planned for. Client ambiguity needs to be eliminated and delinquent clients should experience the sanctions they were warned about, or the programme may quickly unravel. Ground rules must be communicated to all potential clients in order to ensure complete and timely repayment rates and the successful growth of the MFI.

According to CGAP definitions, variables associated with an MFIs default risk include PAR, which is the most accepted measure of portfolio quality. PAR is the outstanding amount of all loans that have one or more instalments of principal past due by a certain number of days. When referring to PAR, an MFI should always specify the number of days for example (PAR >30 days).[87]

The write-off ratio represents the percentage of an MFI loans that have been removed from the balance of the gross loan portfolio because they are unlikely to be repaid. A high ratio may indicate a problem in the MFI collection efforts. However, write-off policies vary, which makes comparisons between MFI difficult. As a result, analysts may present this ratio on an adjusted basis to provide for uniform treatment of write offs. The adjustments to the write-off ratio may increase or decrease the value of loans written off by removing or adding back delinquent loans to the gross loan portfolio in accordance with an international or national standard for writing off loans. Lastly, we have the risk coverage ratio, which shows how much of the PAR is covered by an MFI loan-loss allowance. It is a rough indicator of how prepared an institution is to absorb loan losses in the worst case scenario. MFI should plan according to the age of their PAR: the older the delinquent loan, the higher the loan-loss allowance. For example, a ratio for PAR > 180 days may be close to 100 per cent, whereas the ratio for PAR > 30 days is likely to be significantly less. Thus, a risk coverage ratio of 100 per cent is not necessarily optimal.[88]

TABLE 3. RISK INDICATORS FOR SELECTED MFIS*

Country	MFI	Provision for loan impairment/assets	PAR > 30 days	Write-off Ratio
Iraq	Al-Thiqa	6.11%	3.26%	13.06%
Lebanon	Al Majmoua	-0.71%	3.96%	3.63%
Lebanon	Ameen	-1.28%	1.41%	0.42%
Lebanon	Makhzoumi	0.22%	6.40%	0.25%
Palestine	ASALA	15.38%	58.30%	
Palestine	FATEN	1.67%	6.33%	0.76%
Palestine	PARC	0.03%	72.00%	
Palestine	Ryada	14.95%	46.55%	31.68%

Source: MIX Markets Database.

* *Refer to Appendix 3 for a profile of the mentioned MFIs.*

Table 3 above provides data on a sample of MFIs in Iraq, Lebanon and Palestine. An expense set aside as an allowance for bad loans (customer defaults, or terms of a loan have to be renegotiated, etc).

[87] CGAP (2006).

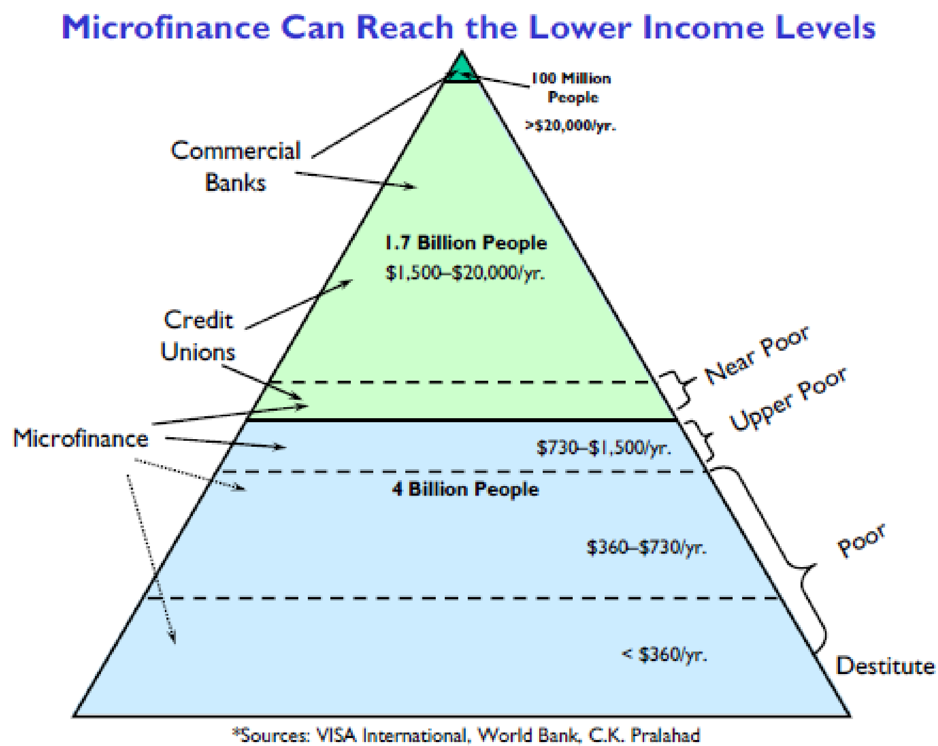
[88] Ibid.

To cope with risk, MFIs should most importantly monitor their activities through keeping track of the foregoing indicators and making sure they are directing their efforts towards minimizing any risk-related factors which hinder their performance.

C. MAXIMIZING MICROCREDIT PROGRAMMES' OUTREACH AND SOCIAL IMPACT FOR PEACE

Outreach is defined as the efforts put in extending microfinance services to those who are not served by financial institutions. It can be measured in two ways: breadth which is the number of served clients and the volume of services (for example total portfolio), or depth which is the socioeconomic level of clients which the MFI can serve.[89]

Figure. Outreach of different institutions



When it comes to outreach directed towards the poor, figure 1 suggests that the bulk of the world population which earns less than US$ 1,500/year, including the upper poor, poor and destitute, does not get any financing through the traditional practice of commercial banks and credit unions since these institutions only finance people who have means to repay their loans. Clearly, microfinance can reach the lower levels of income which commercial banks are either not interested in or are not willing risk financing. Microfinance gives this underserved component of the population access to financial services to help them retain their economic activities, generate income and sustain themselves. When it comes to the Arab region, as mentioned earlier, there is no clear definition for the targets of MFIs. Different institutions have different targets: some targeting the upper poor, others focus on the poor and still others investing in the destitute. Best practice of microfinance does not encourage lending to the destitute.

The main focus of MFIs should be the poor. As we can see in figure 1, there are 4 billion people who are not benefiting from the services offered by commercial banks and other financial institutions. This

[89] Lafourcade, Isern, Mwangi and Brown (2005).

massive market, which without microfinance would be unexploited, should be served to create opportunities and make use of abandoned resources. Although mainly directed towards the upper poor and poor, microfinance could trickle down to the destitute through capacity-building and job creation.

Intermediaries should focus mainly on the entrepreneurial poor, and should engage in client-appropriate lending tailored to the needs of the specific market they are serving. Savings mobilization facilitates small deposits and provides ready-to-access funds when they are legally permissible. Significant progress in expanding client reach and market penetration is needed, demonstrating both strong client response to services offered and competence in service delivery management.

D. TRAINING AND TECHNICAL ASSISTANCE

To help MFIs build their institutional capacities, it is important to provide them with easy access to training and technical assistance. The region obviously lacks suitable training in microfinance best practice, and needs more tailored technical assistance. Training needs vary widely given that new microfinance programmes need basic training while older programmes are facing second or third generation issues associated with larger, more complex organizations. Older programmes need far more specialized training and technical assistance.[90]

Many of the region's microfinance programmes are part of larger institutions such as international NGOs or governmental or quasigovernmental organizations (such as social funds or state-owned development banks). Such structures can limit growth, and after reaching a certain level of development an MFI should consider spinning off or transforming into a separate legal entity. The reasons for that include the need for internal rules or procedures that might conflict with other activities or objectives of the parent organization. There may be a need for a clear identity separate from the parent organization, to avoid sending clients mixed signals.[91]

Several training initiatives have been undertaken to bolster microfinance training in the region. In the summer of 2000, 35 of the 120 participants in the Boulder course were from the region. To date, more than a hundred individuals from the Middle East and North Africa have attended the programme. Thus, donors are willing to help MFI access best practice. Regionally, several initiatives have emerged, some have been tested and implemented while others are still at the embryonic stage.[92]

In addition to these initiatives, the CGAP has forged partnerships with training institutes around the world to provide financial management courses to microfinance institutions since 1997. Having identified the insufficient skills of microfinance managers and staff as the main constraint to the development of the industry, the CGAP initiative seeks to enhance performance through training. Moreover, many institutions in the Middle East and North Africa are developing local training directed at loan officers and mid-level staff.[93]

Training and technical assistance programmes cross-subsidized by financial programmes may increase costs of the operation with no consequential improvement in the effectiveness of the financial services. Programmes that provide exclusive financial services are as effective as programmes that provide loans and compulsory credit-related training, and financial programmes combining only minimum non-financial with financial services are more likely to attain self-sufficiency than programmes that provide an integrated assistance package to micro and small entrepreneurs.

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[90] Brandsma and hart (2004), op. cit.

[91] Ibid.

[92] Ibid.

[93] Ibid.

If training programmes are offered by NGOs granting financial services, they should be demand-driven, provided on a cost-covering basis and separately from financial services. "In Ethiopia, training in tailoring by an NGO financed by GTZ was less successful since the market was already saturated with tailors while training in construction was in high demand. Training provided free of cost along with loans in El Salvador was less effective in increasing loan repayment since loans were considered as payment for the participation in the training programmes."[94]

Challenges remain while the region's best practice programmes have managers with a private sector or banking background which generally enhances a programme business orientation and quest for sustainability. But getting such managers is hard, and keeping them is often harder. Thus microfinance institutions face major human resource challenges: attracting suitable candidates, investing to improve their skills and retaining them.[95]

E. EXTERNAL SUPPORT AND DONOR STANDARDS

The purpose of setting common standards for donor agencies supporting broader access to financial services for MSEs so that donors can work in concert to ensure that lessons of success are translated to the institutions they support. Donor support to MFIs revolves around two main pillars: outreach and sustainability. The first aims at a wider cliental base, and the second provides the means to expand the outreach. There are numerous types of MSE clients who have different characteristics and demand different services. As a result, it is important to encourage a range of specialized institutions which use focused methods to serve their particular markets. These institutions can include "commercial and development banks, credit unions, mutual or community banks, non-governmental organizations (NGOs), finance companies, cooperatives, savings and credit associations and other specialized intermediaries".[96] Fundamental principles of finance must be observed by all institutions if they are to succeed. In addition to that, donors should aim their support mechanisms to match international best practice and long-term development of a sound financial system.

Strengths of intermediaries seeking support should include an institutional culture, structures, capacities and operating systems. These can help sustain service delivery to a wide range of low-income clients. Requirements include a "sound structure, independence from political interference, good fit to local context, competent staff, a strong expansionary and sustainable business plan, and mission and vision to direct the institution's purpose, ownership and accountability".[97] Also a point of strength is accurate MIS that are actively used to make decisions and provide accountability for funds. These systems are vital for effective and efficient management. Operations which efficiently manage small transactions with high productivity are also important in an intermediary. These are measured by variables like loans per staff and the operating costs as a percentage of average annual portfolios. In addition to that, meaningful and transparent financial reporting which conforms to international standards and allows donors to adequately evaluate performance should be practiced. Intermediaries should focus mainly on the poor and should engage in client-appropriate lending tailored to the needs of the specific market they are serving. Savings mobilization facilitates small deposits and provides ready-to-access funds when they are legally permissible.[98] Grants should be used in institutional development which is applicable at all stages of an institution's life. Institutional development may include capitalization to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale, managing operational losses (although donors should avoid covering operating losses except during a clear,

[94] Nagarajan (1997), op. cit.

[95] Ibid.

[96] World Bank (1995).

[97] Ibid.

[98] Ibid.

time-limited start-up or expansion phase) and the purchase of fixed assets which contribute to the equity base of the institution.

Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk inherent to loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine savings mobilization efforts of savings and credit associations by making loans available to them below the cost of mobilizing funds locally.

The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as investor equity, from both official and private sources. Donor support can help leverage private investment through second-tier operations, which raise funds from commercial sources and lend to MFIs, and partial guarantees of loans made by commercial banks to NGOs.

Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grant or loan) to MSEs, donors should ensure that they coordinate their efforts such that institutions are given clear incentives to become financially viable. In particular, donors need to coordinate appropriate interest rates and other terms on which assistance to any given institution is supplied.[99] Donors should also coordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth. Donors should require regular reporting on institutional performance and should base funding decisions on achievement of performance targets. The following tables cover the minimum raw data that should be reported, but do not include analytic indicators, such as financial ratios or adjustments for subsidy or inflation. The intent is to ensure the quality and comparability of data so that financial analysis can be conducted in a way that both donors and programmes can interpret. Meaningful analysis requires a firm base of data. These indicators are intended to furnish such a base.[100]

Donor funding should complement, not replace private capital. Coordination of donor agency activities in microfinance has the potential to enhance economies of scale and promote learning. At a minimum, donor cooperation and clear communication with microfinance providers can identify appropriate interventions, avoid duplication of funding and conflict and clarify variances in areas and methodologies that different donors choose to support. Particular goals and target groups include poverty reduction through targeting poor households; economic development through targeting sustainable local businesses; job creation to promote stability through a focus on unemployed young men in conflict areas; reduction of poverty and gender disparity through a focus on women; and poverty reduction or improved economic activity through a focus on rural areas and agriculture. Additionally, according to the priority of the donor, microfinance operations have had a focus either on rapid delivery of services in targeted communities or on building sustainable operations for long-term success.[101]

The international organizations have tended to resist providing directed services in areas that are not stable, evidencing a preference for focusing on building sustainable operations. Often the same donor will express an interest in both aspects of microfinance development. Donors may also wish to explore other alternatives besides microfinance (for example, cash-for-work) that may be a better fit with this and other specific objectives.[102]

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[99] Ibid.

[100] Ibid.

[101] USAID IZDIHAR (2007), op. cit.

[102] Ibid.

Funding based on large, ongoing subsidies with a charity rationale has failed. Such programmes have drained resources without becoming sustainable and have contributed to the mistaken notion that the poor are un-bankable. Donors should provide financial and other support to ensure the quality of the services the MFI provides with the widest possible outreach. Donors should foster the efforts of the MFI to scale and attain financial self-sufficiency and independence from donor support. Donors should ensure that institutions, in their effort to become sustainable, maintain a focus on offering appropriate services to the poor.

In the box below, the experience of East Timor provides valuable lessons even though it comes from a country outside the region. East Timor's experience shows that prefabricated solutions especially by international agencies should not be taken and implemented without a thorough understanding of the situation in the country, the status of the clients and their needs.

Box 2. East Timor- A story of a failure

In 1999, after East Timor's independence from Indonesia, the World Bank, the IMF, and the Asian Development Bank (ADB) launched the restructuring of the country's economy. They initiated the rural economy and decentralized the government through Community Empowerment Project (CEP) which grants loans to small community projects such as repairing roads, water sanitation projects and microcredit-funded kiosks. Instead of reshaping Timor's economy, this resulted in community conflicts, indifference and poor project sustainability.

By moving into reconstruction, the World Bank aimed at delivering speedy material assistance and to build robust institutions of local governance that would "empower" communities to engage in their own development. The communities under the CEP had to abide by the World Bank's guidelines, supervision, missions and key Performance Indicators, giving them too little autonomy. Deadlines for quick disbursement of project funds and detailed bureaucratic rules plunged the communities in confusion and conflicting situations. In addition to that, giving credit to micro entrepreneurs placed most of them in a precarious position, as many spent the money on urgent needs or saw only one business option: run a kiosk. In fact, 54% of CEP microcredit loans went to kiosks, leading to few customers and too much competition. Not only were most of the loan recipients illiterate and ignorant of their businesses' health and sustainability, 70% of microcredit cases were deemed to be incapable of breaking even and thus paying back the original loan.

The World Bank tried to build a nation on the quick by imposing free-market economics on the grassroots, but there are clear limits to what credit and some accounting skills can remedy. Also, lacking a political legitimacy and perceived as essentially a funds distributor, the Bank failed at bringing democracy to the countryside. Instead of taking advantage of the local legitimacy and technical knowledge, the Bank bypassed these sources and struggled to establish its "civilising" mission.

Source: Moxham (2004).

IV. CONCLUSIONS AND RECOMMENDATIONS

A. CONCLUSION

International evidence shows that there is a need for a clear strategy set by the government through which goals and objectives have to be set depending on the country's needs and market characteristics. Donor and government coordination is an essential component in sound microfinance practice. This does not mean that over-regulation is a positive thing. The governmental role should be limited to guiding the process by regulating deposits of the MFIs, and providing technical, financial and outreach support. This role also includes formulating supportive policy and regulatory environment, avoiding the distortion of the market by direct service delivery with subsidized fees and avoiding policies that negatively impact the effectiveness and efficiency of microfinance institutions. Thus governments should enable financial services not provide them directly.[103]

Attracting successful international MFIs is also an effective strategy as these institutions have experience, reputation and access to support from parent bodies. Microfinance investments should have a long-term scope as the development of microfinance capacity is a slow and costly process. In addition to that, facilitating cooperation and partnerships between public and private players is essential to enhance access to such key factors as financing, skills and basic services. Access to broader financial options should be facilitated. Therefore, the continued development of domestic financial markets coupled with skill-building for regulators and private financial institutions is necessary.

According to microfinance best practice, microcredit institutions should adapt their services to meet the needs of the local client population especially in times of conflict, offering short-term loans or small loan amounts, stepped lending or opening offices in accessible locations.[104] Like any other business, MFIs should work on keeping their costs down. This reduction will eventually trickle down to the client through lower interest rates, operational and processing fees. The dependence on timely repayment means that MFIs should create incentive programmes that motivate clients, and must work towards recovering long-term costs, although operations typically assume losses in the initial start-up period. In addition to that, scaling-up outreach by steadily increasing access to larger numbers of people is critical to organizational viability. The nature of the post-conflict situation will remain correlated with the nature of the conflict and its intensity. Each MFI should work on maximizing knowledge of other case studies on countries with similar issues, but the way to deal with conflict should be adapted depending on the specific characteristics of the country, its economy and business culture.

Specifically in conflict-affected areas in the region (Iraq, Lebanon and Palestine profiled in section 4.2), there is a need to revise the regulatory framework for microfinance, and consequently develop local MFIs into professional and financially stable organizations. Second, creating partnerships between MFIs, the private sector, the commercial banking sector and international microfinance support organizations will help in making this sector more developed and more resilient to conflict. This can be facilitated by establishing specialized microfinance units that will provide support, guidance and monitoring and a link between the governmental vision and the NGOs, public and private organizations engaging in microfinance activities. Third, establishing an advisory framework of microfinance policies can also be used by MFIs to introduce international best practice. Introducing annual ratings of MFIs will facilitate competitiveness, analysis and benchmarking of the sector. Ensuring sustainability and growth of the organizations requires appropriate governance and access to commercial funds. To reach capacity, institution-building and legal transformations are a key requirement. Small enterprises could be supported through ensuring better access to markets, finance and business linkages. In addition, particular efforts should be directed towards youth, women and enterprises that have the capacity to employ many people like family farms. Broad alliances for

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[103] Staschen (1999), op. cit.

[104] Larson (2001b).

microfinance could also trigger better lending and develop financially sustainable models. Innovative schemes are also needed to transform migrant remittances into long-term productive investments in their home countries especially in areas of conflict where people flee the countries to seek less troubled environments.

To promote the microfinance culture in the region, there is a pressing need to educate governments, NGOs and the general public. Most MFIs still rely on subsidized funding which makes them less financially self-sufficient. Thus, regulatory environments should be set in a way to create a competitive edge and provide a solid ground for developing activities targeted at new funding sources. Facilitating licensing, entry and exit procedures, setting capital requirements to give MFIs a status that will allow them to raise funds from private investors in loans or equity are all important aspects of improving the sector and making it more resilient to uncertainty and conflict. Allowing MFIs to raise equity will give them a cushion in times of uncertainty and help them survive and benefit more people. Legislative measures should also be taken to prevent the risk of corruption in the industry especially for MFIs benefiting from external financing.[105] A further step is to encourage commercial banks' participation in microlending. Microfinance outreach can encourage the empowerment and increased productivity of women in their communities.

While unregulated MFIs are reaching poorer clients, they have higher costs and smaller operations volume; these institutions will need to scale up, transform, or merge with other institutions to achieve levels of efficiency that can guarantee their continued operation. Cooperatives compare favorably for savings mobilization, even though, on average, they do not lend as much as other types of MFIs. Given their lower operating costs, cooperatives are well-positioned to improve financial performance and remain competitive. Commercial banks are entering the market, and competition is increasing in many countries. MFIs will need to innovate and provide high-quality services to retain clients and remain competitive in their local financial services markets. In addition to regulation of the institutions, judiciary reforms are important for contractual reinforcement.[106] There is a need to promote further awareness regarding financial products and the differences between them. MFIs should work to minimize their costs and, when applicable, offer group lending methodologies which imply economies of scale and thus reduced costs.

Although donor funding is highly necessary, it should complement, not replace, private capital. MFIs should be regulated to attract capital which will help these institutions become more sustainable and resilient to uncertainty. Voluntary savings and deposits are the largest and most liquid financing sources for MFIs. Additionally, these savings meet the need for local savings services which is underserved in most cases. Donors should avoid NGO dependency and should specify exit options from the start.

Microfinance should not be mixed with relief or charity work because it functions very differently from other developmental tools. Some initiatives may target the entrepreneurial poor, while others target the upper poor or the low-middle classes. Other initiatives, if they have the capacity, may invest in high risk groups like the extremely poor and make them suitable to become entrepreneurial through instruments like savings and insurance, termination payments or even microgrants. Therefore, other instruments such as food-for-work, public work programmes, capacity-building efforts, and business development services to prepare the poor and the marginal groups to take advantage of economic opportunity should not be forgotten in the quest to bring financial services to the underprivileged. MFIs have also engaged in training and capacity-building for the underserved poor in many countries across the world. Especially in a post-conflict environment, humanitarian concerns and microfinance work should not compete. The two should be integrated in public policies in order to capitalize on microfinance practice to maximize humanitarian aid.

In conflict environments, microfinance could decrease the intensity of the conflict as it is providing people with resources to improve their living conditions. It is important to understand at which stage of

[105] MIX (2009).

[106] Lafourcade, Isern, Mwangi and Brown (2005), op. cit.

conflict the country is in before engaging in any form of microfinance activities, and it is important to study the nature of the conflict before implementing anything. Some MFIs engaged in conflict resolution between different parts of the community after the conflicts have ceased. It is clear that MFIs can offer a lot to the communities in which they operate and the diversification of their services is important for them to grow and decrease their portfolio risk. Initially, the most important point is to mobilize efforts towards avoiding the recurrence of conflict in order to boost investor confidence. The next step is to achieve a quick transition from conflict which avoids donor dependence, though this should not be undertaken through rapid, uncoordinated reforms. This should be followed by committed efforts by donors and Governments to restore trust in the country's institutions. Coordination among the stakeholders in the microfinance sector should be increased starting from the initial steps of the programme, and financial products which ensure economies of scale and scope should be sought out. Institutions should clearly identify their outreach and sustainability plans. Most importantly, best and worst practice especially from countries with similar conflict environments should be examined to try to learn from the mistakes of others and identify lessons learned from successful solutions.

Based on international best practice and field experiences, this paper concludes that the main focus of microfinance should be directed towards poverty alleviation. The outreach of microfinance services should be increased to meet the high demands of a large population base which lacks access to financing and thus is prevented from engaging in revenue-generating activities. Increasing outreach should not simply implement strategies that worked elsewhere, but should be done in a way that takes into consideration the specific needs of the population in question. Although conflict has harmful effects on the MFIs, it is evident that many institutions proved resilient even in highly dangerous environments. Although they lost a considerable amount of resources, they were able to maintain their place and resume their services in the market.

This report has presented unique case studies from the ESCWA region, which is characterized by uncertainty due to recurring conflicts, and has shown that MFIs are able to survive adverse political and security conditions if they have the flexibility, sustainability and resources to adjust their products and procedures to overcome the obstacles brought about by conflict and political turmoil. Using data on the microfinance sector and household's livelihood like consumption and GDP per capita, this report proved the significance of the impact of microfinance activities on people's livelihood and employment generation.

While the above recommendations and conclusions apply to most of the conflict-affected countries in the ESCWA region, below are some specific recommendations for the three conflict-affected countries tackled in this report, namely Iraq, Lebanon and Palestine.

B. Recommendations

1. *Iraq*

Several recommendations can be made to actors involved in the microfinance business in Iraq. In the first place, the Government of Iraq should create the necessary conditions conducive to the creation of a positive environment for the development of microfinance in the country. This would entail reviewing and reinforcing its regulatory framework. The laws regulating the industry should be strong. At the same time they should not cause unnecessary impediments to the industry. In a wider context, the Iraqi Government should set policies that stimulate financial services for businesses and borrowers while also protecting depositors. The government should clamp down on corruption and improve the business environment, including access to markets and infrastructure. It should also put in place programmes to support the needs of MSEs.

With respect to the international community, a diversification of funds should be envisaged. This would entail the increasing participation of more NGOs and even international institutions like United Nations agencies. ESCWA could contribute decisively in the area of capacity-building. This could be done

by organizing trainings and seminars to increase the capacity of Iraqi officials on the technical aspects of microfinance.

Izdihar also offers some recommendations for donors. Their main tasks would be to clearly define the concept of microfinance in Iraq, assist in resolving regulatory and legal issues and set and adhere to clear reporting guidelines. They can also assist in raising awareness of the topic, provide support or training and encourage networking within the Iraqi microfinance community. Izdihar can support bank linkages and expanding services related to microfinance as the industry continues to evolve under very challenging and unstable circumstances.

Many important challenges for the microfinance industry in Iraq remain. First the lack of political stability after the change of regime has made the operations of microfinance institutions very difficult. The lack of security and banking infrastructure has impeded the development and expansion of this industry. Even if the situation is beginning to improve, Iraq is a post-conflict society with all which this categorization entails. In many cases MFIs have not been able to transfer funds between branches and have had difficulties processing loan payments and producing correct records. Additional investment in microfinance development and expansion remains critical.

Nevertheless, reasons for optimism also exist. Demand for microfinance services in Iraq is high. There is a need to re-energize business activity through microcredit loans to micro and small business entrepreneurs. Many microfinance activities have yielded positive results and have benefited wide sectors of the population.

2. *Lebanon*

Lebanon constitutes a typical post-conflict country, as opposed to the ongoing conflict situations in Palestine and Iraq, and progress still needs to be made to improve the microfinance sector in this country. Indeed, rather than create new MFIs, it would be more appropriate to upgrade and improve existing ones.

There is an urgent need for human resource development in the microfinance sector. Advisory services and training, with a focus on best practice in credit methodology and marketing, are crucial. There is also a need for additional funding to help providers expand their product portfolios and reach in the region, thus increasing access to finance.

The Government should play a critical role by implementing effective policies to ensure the soundness of financial service providers, minimize market distortions, and make MFIs subject to the supervision and regulatory requirements of the Central Bank. More specifically, the Government should develop an appropriate legal environment through:

1. Appropriate and enforceable credit laws. Appropriate laws will facilitate collection and increase accountability of the client and must allow for cost-effective enforcement through the courts and on the ground.

2. Appropriate institutional regulation. The Government should operate within the institutional development matrix to assist providers in their progress along the development continuum.

Another important role for the Government is information sharing through the development of an adequate "Central des Risques" to allow for the sharing of information between various organizations on delinquent clients. This organization could provide basic statistics on microenterprises in Lebanon, such as number, location and typical profile. Furthermore, the government should provide operational tools such as basic maps. Best practice should also be promoted within the context of information sharing. International examples have shown that best practice can include:

1. No subsidies (interest rates).
2. Policies that encourage small loans with short maturities.
3. Delivery of services in a market-oriented manner.
4. The grounding of actions in a well-articulated long-term plan.
5. Promotion of partnerships between donors and the private sector.

3. *Palestine*

While Palestinian MFIs suffer from the ongoing occupation and ensuing economic devastation of both Gaza and the West Bank, recommendations can be suggested with regards to internal and institutional constraints of MFIs in Palestine.

The first challenge for the microfinance players in Palestine is to resolve the apparent paradox of financial sustainability versus social profitability. In order to fulfil their mission of social profitability, the financial sustainability of MFIs has to be achieved.

Palestinian MFIs must take into account that product design and delivery should allow for general instability and potential economic interruptions. In other words, they must be flexible.

External donor aid is the most important source of capital for most MFIs in Palestine and therefore it is important that the donor community approaches microfinance activities from a development perspective rather than as a relief activity. Practitioners should work together with donors to design funding mechanisms that permit continued institutional development of the microfinance programme after the emergency funding has expired.

There needs to be improved collaboration between PMA and MFIs which would help address the challenge of the institutional framework, promoting a deeper understanding of the differences and complementarities between banks and MFIs. There needs to be an expansion of banking laws in order to open banking facilities to MFIs. In addition, it is necessary to change the rules that govern MFIs in order to facilitate their governance, through mechanisms used in the Not for Profit Company Law (combining advantages of the non-profit law with company law).

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