

MAKING MICROFINANCE WORK *BETTER* IN THE  
MIDDLE EAST AND NORTH AFRICA

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## Preface

This report analyzes microfinance in the Middle East and North Africa and offers recommendations on how to further develop the industry. The report, aimed at policymakers, donors, and practitioners, is part of a series on microfinance published by the World Bank's Middle East and North Africa Region. Included in this series are:

- *Making Microfinance Work in the Middle East and North Africa* (1998).
- *Commercial Banking and Microfinance in Egypt: National Bank for Development* (1998).
- *An Application of Islamic Banking Principles to Microfinance* (1998).
- *Spinning Off for Sustainable Microfinance: Save the Children Federation into JWDS, Al Majmoua, and FATEN* (1999).

The last three publications were cosponsored by the Regional Bureau for Arab States of the United Nations Development Programme. The first three reports are available in English and Arabic and can be downloaded at [http://www.worldbank.org/html/extdr/offrep/mena/Micro\\_finance/default.htm](http://www.worldbank.org/html/extdr/offrep/mena/Micro_finance/default.htm). The series, and especially its translation into Arabic, has been very well received.

Relative to other regions, microfinance is a young industry in the Middle East and North Africa. The oldest program is barely 10 years old, and most programs date from the mid-1990s. Between the end of 1997 and the end of 1999 the industry nearly doubled—from 90,000 active clients to almost 170,000. Yet the potential for microfinance is enormous, and today's microfinance intermediaries meet less than 5 percent of the region's demand.

The main source of information for this report was a comprehensive survey of 51 microfinance programs that together account for more than 95 percent of the known programs in the region. The survey was similar to one done in 1998 for *Making Microfinance Work in the Middle East and North Africa*.

The authors did not compare the data from the recent survey (which assessed the industry as of the end of 1999) with the data from the previous survey (which assessed the industry as of the end of 1997). The main reason is that the 1997 survey suffered from a few quality problems. It was the first time many programs had filled out a comprehensive technical questionnaire, and many had problems providing the financial data requested. At that time many programs were not used to financial evaluation indicators such as portfolio at risk, financial cost coverage, and return on assets. This was partly because best practices were not as widely disseminated in the Middle East and North Africa as they are today.

The survey data from 1999 are better than the data from 1997. More programs are implementing best practices, so more are able to complete detailed questionnaires. In addition, more programs have recognized the value of such surveys, generating industry data—and hopefully in the future, industry standards. That the two surveys are not comparable is not a problem because the more recent questionnaire not only covered programs' status as of the end of 1999, it also covered previous years, making comparison and trend analysis possible. Hence the authors were able to compare the 1999 data with the 1997 data collected in the most recent questionnaire.

Microfinance has great potential in the Middle East and North Africa

Many programs that completed the questionnaire did not fit the best practice definition of microfinance—that is, the provision of financial services to the entrepreneurial poor. Instead, they offer very small investment capital loans to the unemployed. The primary mandate of these programs is to reduce unemployment, not necessarily to sustainably provide financial services to the poor. Given the considerable size (measured in number of clients and outstanding loan portfolios) and overall bad performance of these programs, we have placed them in their own category: unemployment lending programs. Data on

such programs were available for Egypt, Jordan, Lebanon, Tunisia, and the West Bank and Gaza, but not for Morocco and Yemen.

Finally, one more category emerged: very small business lending programs. These programs have learned from microfinance best practices and have adapted the lessons to lending to very small businesses that are not necessarily owned and managed by the poor but that employ the poor. Several of these programs are implemented through commercial banks. This type of lending program was found in Jordan, Lebanon, and the West Bank and Gaza.

## Acknowledgments

This report would not have been possible without the cooperation of microfinance programs and organizations operating in the Middle East and North Africa. These programs not only participated in a comprehensive survey on their operations, they also met with us and answered our telephone calls, faxes, and emails. The survey was funded by the World Bank Institute, the World Bank's Thematic Group for Micro and Rural Finance, and the World Bank's Middle East and North Africa Region.

The survey was implemented by six local partners in the region: Kais Al Iriani in Yemen, Michael Cracknell in Tunisia, Maha Khatib in Jordan, Reda Mamari in Lebanon, Fouzi Mourji in Morocco, and Alex Pollock in the West Bank and Gaza. These local partners worked tirelessly to collect information and help respondents fill out the questionnaire. Moreover, our partners provided invaluable background information about their countries. Without their continued support and patience, the survey would never have accumulated the wealth of information that forms the core source of this report. In Tunisia we also received kind assistance from Madame Mansour of Banque Tunisienne de Solidarité.

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Maha Keramane worked many late nights to enter and analyze the data and prepare the figures. The report was edited by Paul Holtz and laid out by Garrett Cruce, both with Communications Development Incorporated, and the cover was designed by James Quigley from the World Bank Institute. The Arabic translations were made by Abdel Shabana of the World Bank with the assistance of Yasser El Gammal of the Human Development division of the World Bank's Middle East and North Africa Region.

Finally, the outcomes of this report would not have been the same without the contributions of Rafika Chaouali (World Bank, Middle East and North Africa Region, Human Development Group), who conducted the first survey in early 1998 and who kindly provided useful information and feedback; Jacques Baudoui and Yasser El Gammal (World Bank, Middle East and North Africa Region, Human Development Group); and Robert Christen (regional coordinator for the Middle East and North Africa in the Consultative Group to Assist the Poorest).



# Executive Summary

## **Microfinance—helping the entrepreneurial poor help themselves**

Microfinance is the provision of financial services to the entrepreneurial poor. This definition has two important features: it emphasizes a range of financial services—not just credit—and it emphasizes the entrepreneurial poor.

Credit for business activity is just one of the financial services needed by the poor. The poor also need credit for emergencies or life-cycle needs, and they need savings and deposit services. But people who need savings do not necessarily need credit, and people who need credit do not necessarily need savings. Moreover, savings are important not only as a service for the poor, but also as a source of funds for microfinance institutions.

The entrepreneurial poor are defined as people who can increase their incomes through economic activities that can move them closer to or even above the poverty line. The entrepreneurial poor do not need assistance for themselves, but they may need help setting up or managing activities that will increase their incomes. In particular, they need help accessing the resources required to develop these activities. Credit is one of those resources. By contrast, the nonentrepreneurial poor—the extremely poor—require assistance simply to survive.

Providing financial services to the entrepreneurial poor increases household income, reduces unemployment, and creates demand for other goods and services—including nutrition, education, and health services. More than 500 million of the world's economical-

ly active poor run small economic activities and businesses. But less than 5 percent have access to financial services.

This “absurd gap” between the supply of and demand for microfinance services is far too large to be filled by government and donor funds. But such funds are not needed, because a growing number of microfinance institutions have shown that poor people are bankable and that banking with the poor can be profitable and sustainable. The poor are willing to pay the high interest rates associated with microfinance in return for quick, convenient, and continued access to well-designed financial services. Simply put, the absurd gap can be filled only through a substantial increase in the number of sustainable and profitable microfinance institutions.

## **Features of the industry in the Middle East and North Africa**

Microfinance is a young industry in the Middle East and North Africa. The oldest program, that of the Alexandria Business Association, started in Egypt just over 10 years ago. In other parts of the world, especially Asia and Latin America, microfinance institutions have been around for several decades. So, in developing microfinance, practitioners and policymakers in the Middle East and North Africa can learn from other regions while adapting programs to their own environments.

The region's emerging microfinance industry differs from those in other parts of the world:

Less than 5 percent of the world's economically active poor have access to financial services

Between 1997 and 1999 the region's microfinance industry nearly doubled, from about 90,000 active clients to almost 170,000

- Expectations are too high: microfinance is not a panacea for or solution to unemployment.
- Microfinance is narrowly defined: most microfinance institutions only offer credit for business activities and do not offer savings or deposit services.
- Governments are interested in regulating microfinance, and several countries have passed laws on microfinance. Such efforts risk jeopardizing the industry's healthy development.
- Second generation issues may slow the industry's growth. Many microfinance institutions are experiencing crises after rapid initial growth and need time to consolidate and restructure.
- Islamic finance methodologies are being applied by new microfinance programs, and existing programs that use Islamic finance—some of them very large—have become more visible.
- Emerging lending programs for very small businesses are being implemented by commercial banks that apply best practices from microfinance to the financing of these businesses.
- Unemployment lending programs have many clients and large loan portfolios and are often confused with microfinance programs.

This report draws heavily on two World Bank surveys of microfinance institutions in the region, one assessing developments as of the end of 1997 and the other as of the end of 1999. Between 1997 and 1999 the region's microfinance industry nearly doubled, from about 90,000 active clients to almost 170,000 (see table). Egypt remains the region's leading provider but has lost market share. Morocco is second, having experienced dramatic growth since 1997—from fewer than 4,000 active clients to more than 42,000. But other countries, such as Lebanon and the West Bank and Gaza, saw their microfinance industries stagnate or even shrink. This was mainly because microfinance players in these countries went through restructuring and consolidation as they faced second generation issues.

### Microfinance indicators in the Middle East and North Africa, 1997 and 1999

Indicator	1997	1999
Number of microfinance programs	60	51 <sup>a</sup>
Number of active clients	90,237	168,817
Outstanding loan portfolio	\$44,624,285	\$77,673,301
Average outstanding loan balance	\$495	\$460
Share of female clients (percent)	31	46
Share of rural clients (percent)	18	21
Leading provider	Egypt	Egypt
Second leading provider	Jordan	Morocco

a. The number of microfinance programs fell because some of the programs included in the 1997 count were reclassified as unemployment lending programs.

Source: World Bank surveys of microfinance institutions.

The average outstanding loan balance dropped slightly, from \$495 in 1997 to \$460 in 1999. This happened for two reasons. First, new programs began by offering small initial loans—loans that will increase with timely repayment. Second, women accounted for a larger share of borrowers (46 percent, up from 31 percent), and women are usually poorer and need smaller initial loans.

As in 1997, most of the region's microfinance programs are local nongovernmental organizations (NGOs), foundations, or cooperatives. Egypt's National Bank for Development is still the only bank in the region actively engaged in microfinance. Although more private banks are making small loans, they are considered very small business lending programs. The absence of government-sponsored microfinance programs has not hindered the industry's development.

Of the 60 microfinance programs surveyed in 1997, 2 were fully sustainable and 8 were close to it. Together these 10 programs served about 80 percent of the region's active microfinance clients—important because clients want continued access to financial services.

Another 10 programs were small but had as their main objective the sustainable provision of microfinance. All these programs were implementing best practices. Most of the region's remaining programs were in bad shape and not implementing best practices. These patterns still hold: most of the region's active clients are served by programs implementing best practices (see table).

### The future of the industry in the Middle East and North Africa

All the programs surveyed were asked how many active clients they expected to serve within five years—that is, by the end of 2004. Their goals were ambitious: together they expect to serve more than 422,000 active clients by that time (see figure). And assuming that new programs are established—for instance, nine more foundations are being set up in Egypt following the Alexandria Business Association model—the region's microfinance industry could end up serving more than 500,000 clients.

Are these expectations realistic? Perhaps not. One reason is that there appears to be a limit to the size and growth of NGOs that only grant credit. The 10 programs that in 1997 were fully sustainable or close to it today serve 63 percent of active clients, down from 80 percent. The 10 programs that in 1997 were small but seeking full sustainability now serve 20 percent of the market, up from less than 6 percent. Finally, a few new programs have emerged with full sustainability as an objective. They serve just 6 percent of clients but are expected to grow rapidly in the next few years.

The 10 leading programs lost market share because they did not grow as quickly as the formerly small but currently sizable programs. The 10 leading programs grew from 71,000 active clients in 1997 to 105,000 in 1999. Though this 47 percent growth is respectable, it appears low given the large unmet demand for microfinance. By contrast, the formerly small programs grew from

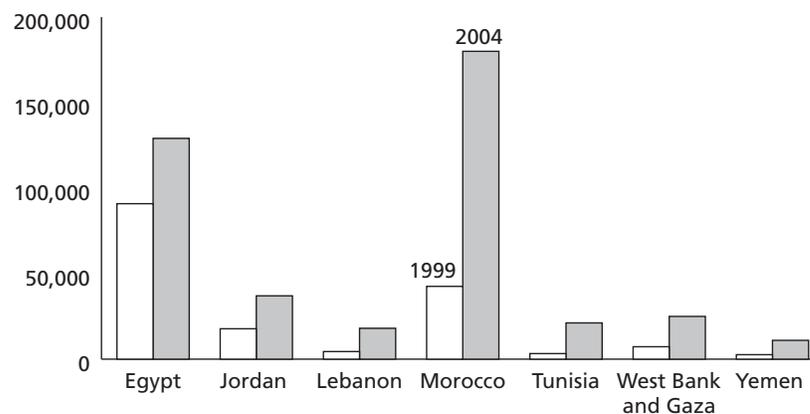
### Number and market share of best practice microfinance institutions in the Middle East and North Africa, 1999

Country	Number of institutions	Number of best practice institutions	Market share of best practice institutions (percent)
Egypt	17	8	90
Jordan	8	3	36 (66) <sup>a</sup>
Lebanon	5	3	91
Morocco	7	3	90
Tunisia	6	1	55
West Bank and Gaza	3	2	96
Yemen	4	4	100
Total	51	24	88

a. The market share of Jordan's 3 best practice programs increases to 66 percent if the sample excludes the microcredit program of a large government agency that does not implement best practices and in effect gives grants, not loans.

Source: World Bank survey of microfinance institutions.

### Active microfinance clients in the Middle East and North Africa, 1999 and 2004 (projected)



Source: World Bank survey of microfinance institutions.

5,000 clients in 1997 to 33,000 in 1999—growth of more than 600 percent.

There are several reasons for the disappointing growth of the 10 market leaders. Some underwent restructuring and consolidation as a result of crises. A few others seem to be resting on their laurels: they are sustainable and are the darlings of donors but seem to lack the drive to reach more poor people. Some, especially those in small markets, have narrow market niches and serve one target group with one loan product. They may have to diversify to grow, targeting other groups and introducing new financial products.

Finally, slow growth may be caused by a lack of funds for onlending. Most of the mar-

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commercially—  
including taking  
deposits

ket leaders still depend on donor funds. But they do not need to. They could start raising commercial funds for onlending by, say, borrowing from banks. Some donors have not encouraged their programs to pursue this route—they too are resting on their laurels.

Some programs in the region have tried to raise funds commercially but have encountered legal and regulatory obstacles. In borrowing from banks for onlending, having the legal form of an NGO can be an impediment because it lacks transparency and accountability. Banks will generally be unwilling to lend to NGOs, especially if they cannot sue them. Two of the region's ten leaders have changed legal form, from NGOs to private companies, in order to borrow commercially. But these changes were recent, so it is too early to tell whether the companies will now be able to borrow from banks.

One of the ten leaders tried to change into a bank, which would make perfect sense because as a bank it could collect savings and deposits. But the \$30 million minimum capital required for banks (in this case in Egypt) was too much of a financial obstacle.

For programs to reach the scale of microfinance institutions in other parts of the world, they must raise funds commercially—including taking deposits. This will also enable them to broaden their approach to microfinance, moving beyond credit for businesses. By mobilizing savings and deposits, they will be able to serve thousands more clients.

In many cases mobilizing commercial funds for onlending will require transforming from an NGO into a private company, bank, or nondeposit-taking financial intermediary. But even more important will be the transition from a program to a locally owned and managed institution. Donors and practitioners alike should be prepared for the array of new training needs that may arise for programs that decide to transform into a new legal entity and institutional form.

Policymakers, meanwhile, should be prepared to create legal environments that are appropriate for prudent but growing microfinance. This may well be the greatest challenge facing the region's microfinance industry over the next few years.

# The Recent Evolution and New Challenges of Microfinance

This section offers an overview of the basic concepts and target groups of microfinance. It elaborates on the best practices underlying sustainable microfinance and reviews recent research on the impact of microfinance. Readers familiar with the basic concepts of microfinance could skip this section.

## What is microfinance?

Microfinance is the provision of financial services such as savings, deposit, and credit services to the entrepreneurial poor. Microfinance activities usually involve:

- Small loans, typically for working capital.
- Informal appraisal of borrowers and investments.
- Substitutes for collateral such as group guarantees or compulsory savings.
- Access to successive and larger loans based on repayment performance.
- Streamlined loan disbursement and monitoring.
- Secure voluntary savings products (Ledgerwood 1998).

This definition has two important features: it emphasizes financial services—not just credit—and it emphasizes the entrepreneurial poor.

### *Financial services*

The poor need a variety of financial services, of which credit for business activities is just one. They also need credit for emergencies or to fund life-cycle needs, and they need savings and deposit services. But people who need savings do not necessarily need cred-

it, and people who need credit do not necessarily need savings. Moreover, savings are important not only as a service for the poor, but also as a source of funds for microfinance institutions.

### *The entrepreneurial poor*

The development community distinguishes between two groups of poor people: those who can increase their income by themselves and those who cannot. Members of the first group can engage in economic activities that can move them closer to or even above the poverty line. Members of the second group have no capacity to undertake any economic activity, either because they lack skills or because they are destitute (UNCDF 1996).

Members of the first group are called the entrepreneurial poor or economically active poor. The households of the economically active poor may have some assets (such as land), and some members may be employed or run a microbusiness. These households have “reliable income, freedom from pressing debt, sufficient health to avoid incapacitating illness, freedom from imminent contingencies, and sufficient resources (such as savings, non-essential convertible assets and social entitlements) to cope with problems when they arise” (Hulme and Mosley 1996).

Members of the second group are called the extremely poor. Lacking economic viability (the ability to meet basic needs such as food, shelter, and clothing) and economic security (the ability to protect household assets and income from shocks), these households live below the minimum subsistence

The poor need a variety of financial services

Providing financial services to the entrepreneurial poor increases household income, reduces unemployment, and creates demand for other goods and services

level. The World Bank considers people poor if they live on less than \$1 a day, and extremely poor if they live on less than \$0.75 a day. About two-thirds of the people defined as poor are extremely poor.

Microfinance targets the entrepreneurial poor. The entrepreneurial poor do not need assistance for themselves, but they may need help setting up or managing economic activities that will eventually increase their income. In particular, they need help accessing the resources required to develop those activities. Credit is one such resource. The nonentrepreneurial poor—the extremely poor—do require assistance for themselves, simply to survive.

The distinction between these two groups of poor people can help policymakers better allocate resources. In *The Microfinance Revolution*, Marguerite Robinson offers a “poverty alleviation toolbox” for policymakers (figure 1). The first column shows three income levels: lower middle income, economically active poor, and extremely poor. The economically active poor category is wide ranging, from those living just above extreme poverty to

those about to enter the lower-middle-income category. The middle column shows the financial services that are typically suitable for the different income levels, with microcredit appropriate for both lower-middle-income individuals as well as most of the economically active poor—including some below the official poverty line. Microsavings can even reach the lowest levels of the economically active poor, some well below the poverty line. The third column shows nonfinancial poverty alleviation tools that are appropriate for people below the poverty line and essential for the extremely poor. These tools are funded by direct subsidies and grants.

**Features of sustainable microfinance**

Providing financial services to the entrepreneurial poor increases household income, reduces unemployment, and creates demand for other goods and services—especially nutrition, education, and health services. More than 500 million of the world’s economically active poor run micro and small

**Figure 1. The poverty alleviation toolbox**

Income level	Commercial financial services		Subsidized poverty alleviation programs
Lower middle income	Standard commercial bank loans and full range of savings services		
Economically active poor		Commercial microloans	
			Interest-bearing savings accounts for small savers
	----- Official poverty line -----		
Extremely poor			Poverty programs for such purposes as food and water, medicine and nutrition, employment generation, skills training, and relocation

businesses. But less than 5 percent have access to financial services.

This “absurd gap” between the supply of and demand for microfinance services is far too large to be filled by government and donor funds. But such funds are not needed, because growing numbers of successful microfinance institutions have shown that the poor are bankable and that banking with the poor can be profitable and sustainable. The poor are willing to pay the high interest rates associated with microfinance in return for quick, convenient, and continued access to well-designed financial services. Simply put, the absurd gap can only be filled through a substantial increase in the number of sustainable and profitable microfinance institutions.

Since the 1980s microfinance has grown substantially. It has also undergone a revolution, moving from government- or donor-subsidized credit delivery systems to self-sufficient institutions providing commercial microfinance. Credit schemes subsidized by donors and governments try to reduce poverty by providing credit, often along with complementary services such as skills training and programs for literacy, numeracy, health care, nutrition, family planning, and the like. Under this approach, known as the poverty lending approach (Rhyne 1998), donor and government credit is provided to poor borrowers, typically at below-market interest rates.

Such credit is intended to help the poor—especially the poorest of the poor—overcome poverty and gain empowerment. Except for mandatory savings sometimes required as a condition for receiving a loan, the mobilization of local savings is normally not a significant part of the poverty lending approach to microfinance (Robinson 2001). Many of these schemes have low repayment rates and high arrears, and so deplete their capital. They need continued injections of donor and government funds simply to maintain their client base.

This approach is not sustainable if the goal is to reach hundreds of millions of poor people. Only profitable and commer-

cial microfinance institutions can make financial services available on a large scale. And only profitable microfinance institutions can cover their operational and financial costs. Operational costs include asset depreciation, loan losses, and the administrative costs of making very small loans—costs that are high for even the most efficient microfinance institutions. Financial costs are the commercial costs of funds such as savings, bank loans, and bond issues. Only sustainable microfinance institutions that can attract commercial sources of funds will be able to grow and serve more poor people. Moreover, attracting commercial funds will free such institutions from depending on donor and government funds, which are often unreliable, politically motivated, and come with many strings attached (such as cumbersome monitoring and reporting requirements).

Donor and government funds should be used to subsidize new and growing microfinance institutions for purposes such as start-up costs, staff training, exposure to best practices, technical assistance, and development of management information systems. Subsidizing final borrowers is not acceptable because it undermines sustainability. Subsidizing institutions is necessary but should be based on well-defined and mutually agreed performance contracts. By taking this approach, donors and governments can reallocate scarce funds to poverty alleviation programs that help extremely poor people access social, health, and education services.

Commercial institutions working in the formal financial sector have begun to profitably meet the enormous demand for small loans and savings. *The Microfinance Revolution* discusses five features of sustainable microfinance institutions operating on a large scale: knowledge of commercial microfinance and its clients, institutional ownership, good organization and management, human resource development, and corporate philosophy. These are reviewed below.

Only sustainable microfinance institutions that can attract commercial sources of funds will be able to grow and serve more poor people

Sustainable  
microfinance  
institutions  
share common  
features

*Knowledge of commercial microfinance and its clients*

Owners, boards, managers, and staff of self-sufficient and sustainable microfinance institutions know their business and have a wide range of skills. They know the economic, political, legal, and social structures and practices of the areas they serve. They are familiar with regulations and maintain open channels of communications with regulators and policymakers. They have intimate knowledge of the operations and dynamics of the local markets where their clients operate. They have intimate understanding of the extent and types of demand for microfinance. They know their clients—including their businesses and household dynamics. They have financial expertise, including the capacity to manage portfolio risk and liquidity and to maintain simple and transparent accounting, reporting, and management information systems that provide timely, well-chosen information. Finally, they treat poor clients as valued, respected customers.

*Institutional ownership*

Sustainable microfinance institutions can have a mix of owners, including representatives of the business and banking communities, donors, governments, nongovernmental organizations (NGOs), and so on. These owners share an understanding of and commitment to sustainable microfinance. They define the microfinance institution's mission, establish an effective governance structure, and appoint a governing board. They mandate that the institution set interest rates and fees that enable it to cover all costs and risks and that ensure profitability. Board members act as commercial shareholders and can access additional capital if needed and help the institution avoid or overcome bureaucratic and political obstacles.

*Good organization and management*

Organizational and managerial structures differ within and across countries. But sustainable microfinance institutions share common features such as accountability and decen-

tralization: at every level of the organization—from loan officer to outlet to branch—people are held accountable for their performance and responsibility for performance is decentralized. Moreover, managers are committed to profitably delivering microfinance services to a large number of poor clients. Good managers ensure that their institutions have:

- Effective asset-liability management.
- Products and services that are in demand and that are priced for institutional sustainability and client affordability.
- High loan repayment rates.
- Monthly profit and loss statements and balance sheets issued for every outlet providing financial services.
- Effective cash management.
- Well-designed and well-implemented systems of staff recruitment, evaluation, promotion, and incentives.
- Service locations and operating hours that are convenient for clients.
- High-quality supervision, internal control, and external audit.
- Appropriate management information systems and staff trained in their use.
- Suitable security systems.

*Human resource development*

Because microfinance is labor-intensive, human resource development is a top priority. Sustainable microfinance institutions have well-defined recruitment policies and career tracks, as well as appropriate compensation packages for staff at all levels. There is a culture of accountability and performance-based incentives at all levels. Training and management development are essential.

*Corporate philosophy*

Though corporate cultures vary by country, culture, institutional type, and so on, the basic philosophy is much the same, and success in microfinance is based on the same standards: trust, incentives, commitment, simplicity, and standardization, along with service, transparency, flexibility, accountability, profitabil-

ity, staff training, and knowledge of the local market.

### **Savings and microfinance regulation and supervision**

To reach scale—and hence more poor people—sustainable microfinance institutions must have access to commercial sources of funds. These sources include savings, borrowing from banks, and local and international capital markets. Savings are important not just as a source of funds, but as a service that is needed but largely unmet. Efforts to mobilize savings should be made with caution, however, because they involve other people's money. Not every microfinance institution should collect voluntary savings: certain conditions have to be met beforehand (box 1).

Although some argue that mobilizing savings is the only way for microfinance institutions to achieve scale, caveats exist. Mobilizing savings can be expensive: programs incur administrative costs in mobilizing and maintaining savings, and they also

have to reward the savers. Studies in Latin America have shown that mobilizing savings can be prohibitively expensive and does not always provide a stable source of funds (Schmidt and Zeitinger 1996). Borrowing from commercial banks or accessing wholesale sources of funds—instead of the funds of thousands of little savers—can be more effective and efficient.

Microfinance regulation and supervision are issues only when microfinance institutions start taking deposits and savings—that is, other people's money. But in most developing countries the absence of special licensing and supervision for microfinance institutions is not a binding constraint to the development of microfinance. Rather, the bottleneck is the scarcity of microfinance institutions that can operate profitably enough to pay a commercial cost for a large portion of their funds without decapitalizing themselves. It is irresponsible to license a microfinance institution to take deposits if it cannot pass this test (Christen and Rosenberg 1999).

Although the number of fully sustainable microfinance institutions remains small, it is

To reach scale, sustainable microfinance institutions must have access to commercial sources of funds

#### **Box 1. When should a microfinance institution mobilize voluntary savings?**

As a source of commercial finance for microcredit institutions, voluntary deposits have generated a lot of interest in recent years. Locally mobilized voluntary savings are potentially the largest and most immediately available source of finance for some microcredit institutions. Mobilizing such savings also helps meet the vast unmet demand for local savings services in developing countries.

Three conditions should be met before a microcredit institution starts to consider mobilizing voluntary savings. First, profitable mobilization requires an enabling macroeconomy, appropriate laws and regulations, political stability, and suitable demographics.

The second consideration concerns the supervision of institutions providing microfinance. To protect their clients, especially depositors, financial institutions that mobilize

voluntary savings should be under government supervision. This requires a government that is willing to modify its banking supervision so that the rules for microcredit institutions are appropriate for their activities, and to ensure that the supervisory body is able to monitor these institutions effectively.

The third consideration concerns the history, capability, and performance of the microcredit institution. Before mobilizing voluntary public savings, a microcredit institution should have exhibited consistently good management of its own funds. It should be financially solvent, maintaining a high rate of loan recovery and earning attractive returns. A good track record is important because in many countries low-income people have entrusted their savings to small, unsupervised financial institutions—only to lose their life savings.

*Source:* CGAP 1997a.

Microenterprise development is only one use of microfinance services

growing. Still, donors interested in taking an equity stake in sustainable microfinance institutions are fighting over the same small piece of the microfinance pie (Christen and Rosenberg 1999). In most countries a sustainable microfinance institution could raise the capital needed to use an existing form of financial license. The supply of donor funds available for this purpose exceeds the demand from viable microfinance institutions.

### **The limits of microfinance: challenges for the future**

The poverty alleviation toolbox in figure 1 shows the limits of microfinance. Microfinance mainly benefits the entrepreneurial poor—those just above and just below the poverty line. But microfinance is no panacea: many poor people, especially the extremely poor, do not benefit from it. These limits create challenges for microfinance practitioners and policymakers.

Moreover, delivering financial services to the entrepreneurial poor may not lead to a sustained increase in their incomes, but rather may reduce their vulnerability to shocks and economic stress. A recent study carried out for the World Bank's *World Development Report 2000/2001: Attacking Poverty* analyzed the extent to which sustainable microfinance programs reach poor households and reduce poverty. The microfinance institutions in the study had to have been in operation for at least five years, be operationally sustainable or close to it, and offer voluntary savings. Together these institutions had more than 2.1 million active borrowers and many more savers. The study found that:

- Most microfinance clients are vulnerable nonpoor and moderately poor.
- Microfinance services do not necessarily increase income, but they do increase the range of options open to the poor to protect themselves against shocks. Microfinance services are better at protecting clients from risk than at helping them to cope with a loss.

- Microfinance services are used for a variety of purposes, of which credit for an enterprise is just one of many. Moreover, money is fungible—and fungibility is good.

Flexibility in the use of loan funds enables borrowers to allocate funds to their best advantage. This flexibility is key in efforts to reduce vulnerability. The nagging concern of the 1980s that poor borrowers would consume rather than invest their loans—and therefore have no way to repay them—has almost universally been proven unfounded. As table 1 shows, most loan funds are used for a wide range of investments.

Thus microenterprise development is only one use of microfinance services. Left to their own devices, clients use financial services for a wide range of purposes, such as building human, physical, financial, and social assets and diversifying income sources. This permits people to smooth income and consumption as well as raise income. With access to money, they can better manage cash flows.

The old fear that clients will waste (donor) resources by investing in activities that they would have engaged in anyhow reflects a narrow view of household money management strategies. Such substitution frees up money that the household can use in other ways, precluding the use of other, more negative strategies. Fungibility is not the problem for microentrepreneurs, it is the solution. Financial services help poor people secure lump sums when they need them, from time to time, for different purposes (Rutherford 1999). They need these lump sums to fund life-cycle needs and emergencies, or to grasp an opportunity such as investing in a microenterprise. Thus microcredit for microenterprise investment is just one of the many reasons a poor person sometimes needs to secure a lump sum of money.

Good financial services help the poor convert a series of (often irregular) savings into lump sums of cash. These services could include a savings service that allows borrowers to save first and take the resulting lump sum later, a loan that allows borrowers to take the lump sum as an advance against

**Table 1. Examples of how clients use loans to reduce vulnerability**

<i>Loan use</i>	<i>Examples</i>
To build income base	<ul style="list-style-type: none"> <li>• To diversify income sources</li> <li>• To increase working capital</li> <li>• To engage in nonseasonal income-generating activities</li> <li>• To diversify by starting a new enterprise</li> </ul>
To build asset base	<ul style="list-style-type: none"> <li>• To repair, maintain, or improve a house</li> <li>• To repair, maintain, or improve business premises</li> <li>• To repair a productive asset (such as a boat)</li> <li>• To buy new furniture</li> <li>• To buy fixed or productive assets for a business</li> <li>• To join a rotating savings and credit association (ROSCA)</li> <li>• To acquire basic infrastructure (such as water and electricity connections)</li> <li>• To build a track record for credit</li> <li>• To buy land</li> <li>• To invest in education (say, paying school fees)</li> <li>• To invest in health (say, paying medical expenses)</li> <li>• To maintain reciprocal social networks (say, lending to relatives)</li> <li>• To fulfill a social obligation</li> </ul>
To manage cash and resources	<ul style="list-style-type: none"> <li>• To manage cash flow to cover daily household spending following sickness, death, or natural disaster</li> <li>• To support loss of income due to death or unemployment</li> <li>• To increase creditworthiness</li> <li>• To pay off debt</li> </ul>

future savings, an insurance service that allows borrowers to take a lump sum when it is needed in exchange for a continuous stream of savings, or some combination of these (Rutherford 1999).

This approach to microfinance—making money available to the poor when they need it for whatever purpose—may allow for creative solutions to some of the limits to microfinance, such as the exclusion of the extremely poor. Microfinance services play an important role in smoothing and diversifying sources of income. These services also increase income, but such effects depend on the initial endowments of client households. Because the extremely poor have fewer assets and face more risks when

taking loans, there is a need for better financial products to allow extremely poor clients and their households to build up all kinds of assets.

To date the microfinance industry has paid little attention to clients' risk, apart from focusing on the risk of nonrepayment. Illness, death, and the loss of an income earner can quickly erode improvements in the quality of one's life. From a client perspective, health and life insurance are top priorities. Making easily accessible and flexible loans, emergency loans, flexible savings, and insurance available to respond to these basic needs can only be seen as a win-win strategy for both microfinance institutions and clients.



# Microfinance in the Middle East and North Africa

**A**s noted, microfinance is a young industry in the Middle East and North Africa. The region's oldest program, that of the Alexandria Business Association, started in Egypt just over 10 years ago. In other parts of the world, especially Asia and Latin America, microfinance institutions have been around for several decades. Microfinance institutions and policymakers in the Middle East and North Africa are in the unique position of being able to learn from other regions while adapting the design and implementation of programs to their own environments.

The dimensions of poverty in the Middle East and North Africa differ from those in other developing regions. First, the region has much less abject poverty. In other developing regions many poor people die of hunger or suffer severe food shortages. This is rare in the Middle East and North Africa. Only two countries in the region (Djibouti and Yemen) have per capita incomes below \$1,000. All the other countries in the region are middle-income countries.

Still, those middle-income countries have substantial pockets of poverty, with big differences between regions and groups. Poverty is often far more common in rural than in urban areas, but there are generally far more poor people in urban areas—especially in the slums surrounding major cities such as Cairo or Casablanca. Moreover, women appear to be more disadvantaged in the Middle East and North Africa than in other parts of the world.

Some donors and people in the region have argued that the social and cultural circumstances of women in the region make it difficult to provide them with financial ser-

vices. For instance, women often need permission from their husbands to take a loan or go to a group meeting. In other cases they are legally barred from signing loan contracts or opening bank accounts. Thus some believe that targeting women would be counterproductive. As a result the percentage of female microfinance clients is far lower in the Middle East and North Africa than in other parts of the world. But this situation is slowly improving (see below).

## Key features

The region's microfinance industry differs from those in other parts of the world:

- Expectations are too high: microfinance is not a panacea for or solution to unemployment.
- Microfinance is narrowly defined: most microfinance intermediaries only offer credit for enterprises and do not offer savings or deposit services.
- Governments are interested in regulating microfinance, and several countries have passed laws on microfinance. These efforts risk jeopardizing the healthy development of microfinance.
- Second generation issues may slow the industry's growth. Many microfinance institutions are experiencing crises after rapid initial growth and need time to consolidate and restructure.
- Islamic finance methodologies are being applied by new microfinance programs, and existing programs that use Islamic finance—some of them very large—have become more visible.

The region's microfinance industry differs from those in other parts of the world

Access  
to financial  
services helps  
poor people  
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even poorer

- Emerging lending programs for very small businesses are being implemented by commercial banks that apply best practices from microfinance to the financing of these businesses.
- In terms of active clients and loan funds, unemployment lending programs are big players in the Middle East and North Africa and are often confused with microfinance programs. These programs use an approach similar to the poverty lending approach described in the previous section.

### *Expectations are too high*

Governments and policymakers in the region expect too much from microfinance. This may be partly due to the fact that microfinance has become trendy. The hype appears to be at an all-time high, fueled by well-meaning but damaging initiatives that have even declared access to credit to be a human right. Some donors and practitioners are overselling microfinance, and this does not contribute to a balanced and informed policy dialogue and setting of priorities.

Governments in the Middle East and North Africa face increasing unemployment, especially among young people, and some policymakers have latched onto microfinance as a solution. Other policymakers, sometimes as a result of donor pressure, see microfinance as the solution to poverty. In both cases they are wrong.

*Microfinance is not a solution to unemployment.* The main development objective of microfinance is financial intermediation—that is, increasing poor people’s access to financial services. Creating jobs or reducing unemployment is not the main objective, although jobs may be created indirectly. But these jobs are not numerous and are often limited to retaining the employment (or income-generating capacity) of the microentrepreneur. Moreover, microfinance mainly targets existing businesses or microeconomic activities. Helping unemployed people, who are often not good entrepreneurs, set up a business is incompatible with microfinance best practices.

Discussions with managers of the region’s leading programs confirm this. Several of these programs target women who have been clients for a few years and who have built a sustainable one-woman business activity that contributes to household income. Other sources of household income may include wages, pensions, and the like. But due to increased unemployment in some countries (such as Gaza and Lebanon), the female microentrepreneur has become the only source of household income. The husband, son, or brother of the microentrepreneur may have been laid off or could not find work. Some women have brought their family members to the programs, asking for loans for them. The programs have had to turn them down because they did not have entrepreneurial skills and would be better off working for others instead of managing their own business.

*Microfinance is one of many tools for alleviating poverty.* As noted, microfinance is a powerful tool for certain groups of poor people: those just below the poverty line (the moderately poor) and those just above it (the vulnerable nonpoor). While microfinance may increase income, its main impact is reducing a poor person’s vulnerability to external shocks and economic stress. To put it bluntly, access to financial services helps poor people avoid becoming even poorer.

Many poor people, especially the extremely poor, may not benefit from microfinance. But practitioners should develop financial services, especially savings and insurance, that could help the extremely poor build up an asset base—which over time could enable them to grasp an economic opportunity when it arises.

### *Microfinance is narrowly defined*

Microfinance programs in the Middle East and North Africa mainly offer credit for enterprise investment. But as noted, such credit is just one of the many financial services that poor people need. They also need credit for other purposes—especially emergency cred-

it—and women in particular would also benefit from savings and deposit services. Because of the region's narrow definition of microfinance, many potential clients, especially women, are excluded.

Only two of the region's programs, one in Lebanon and one in Yemen, mobilize voluntary savings. The claim that savings are limited by legal and regulatory constraints is not entirely valid, because these programs offer savings as a true service—depositing the saved funds in banks in the names of their clients. Hence the savings are legal and automatically fall under bank supervision.

A lack of savings and deposit services may explain why some countries, such as Egypt, have a small share of female borrowers. Recognizing this, the leading Egyptian microfinance program has started village banking programs in which groups of women save and receive credit. Although some of these savings are compulsory (that is, a condition of getting loans), women are also free to save only and not get credit.

Some programs do permit emergency loans, such as for medical emergencies or roof repairs, but often only on an exceptional basis. Some of the Islamic programs described below offer such loans (called *has-san* loans) on a regular basis, however.

### *Governments are interested in regulating microfinance*

Partly because of unrealistic or incorrect expectations (sometimes as a result of donor pressure and microfinance hype), governments have become increasingly interested in microfinance. A bureaucrat's automatic response would be to regulate the industry. But this could be dangerous, because regulation could stifle innovation and sustainability. For example, a 1999 Tunisian law on microcredit could stunt the growth of the industry, though it is too early to tell whether that will happen. Morocco has passed a similar law, and Egypt may also regulate the industry.

Governments should not regulate today's microfinance industry. Only when the region's few capable microfinance institu-

tions (of which there are fewer than 10) start taking savings and deposits would regulation be justified. Until then, microfinance institutions need to experiment, innovate, and grow. That the region's microfinance industry nearly doubled between late 1997 and late 1999 in an unregulated environment shows that regulation is not needed. The region's microfinance programs are worried about their governments' intentions. To quote a leading program in Egypt, "better no regulation, than bad regulation." It is no surprise that several microfinance institutions have changed their legal status from NGO to private company. Fear of government intervention has been one of the reasons for doing so.

### *Second generation issues may slow the industry's growth*

A microfinance program is like a new business. Like any new business, it has an organizational evolution (or sometimes revolution) curve. After an initial startup period, many microfinance programs experience rapid growth. Management systems are simple (the owner or manager can often oversee all activities), accounting is basic, and loan portfolio management is easy because staff members usually know all borrowers personally.

But as a program expands, management layers have to be developed. Loan officer supervisors and area managers need to be recruited. Branches may be set up. And loan portfolio management can no longer be done manually. A management information system becomes crucial, as do asset-liability management, internal controls, and audit and financial management. The organization will need to adapt and may face a period of slow growth while it restructures and consolidates managerial and administrative systems. It often will also fine-tune or redesign loan products based on feedback from clients, and it may introduce new products.

In some cases these organizational changes are inspired by a crisis such as the departure of a managing director or the discovery of

**Governments should not regulate today's microfinance industry**

Many programs are too dependent on their leaders

fraud. Several programs in the Middle East and North Africa have experienced fraud because their internal management systems were unable to cope with rapid growth. Fraud created serious shocks for the staff, managers, and boards of these organizations—but they all came out stronger, wiser, and better prepared. (In fact, the changes in organizational development, structures, and professionalism that resulted were so remarkable that one would almost hope for every program to experience some fraud in order to expedite organizational development.) In this context, managers of Moroccan microfinance programs that have seen dramatic growth should exercise caution.

Succession will become an issue in the region. The directors of some leading programs have been around for a while. Some are ready to retire, while others will soon pursue other opportunities. As is the case around the world, many programs in the Middle East and North Africa are too dependent on their leaders, who often have been visionary pioneers in their countries. Visionaries and pioneers are sometimes good creators and innovators but not good managers. As a result some of them may not have paid enough attention to succession. Thus a capable second-line management team, with one or two members being groomed to take over, may not be in place.

During a crisis or organizational restructuring, growth will slow or may even reverse. Once organizational issues are resolved, growth will recover until the next organizational crisis, such as a change in legal status. This is normal.

#### *Islamic finance methodologies are becoming more common*

An important Islamic commitment is the denouncement of usury—the lending of money at exorbitant interest rates.<sup>1</sup> According to the literature, in the pre-Islamic era *riba*—literally translated as excess—referred to the practice of lending. Debtors had to pay a fixed amount above the principal borrowed from lenders for the use of the money. Most

Muslim scholars believe that this additional amount, called *al-riba*, is prohibited, although there are subtle differences in interpretation. But in general, earning money through lending is considered *haram*—in discord with the Islamic code.

Thus it is not surprising that most Islamic finance strategies have tried to remove all forms of fixed nominal interest rates. (Muslim scholars make no distinction between nominal and real interest rates; it is assumed that all interest rates are real and so are considered to hamper investment and employment.) But the abolishment of fixed interest rates does not mean that no remuneration is paid on capital. To the contrary, profitmaking is acceptable in Islamic society as long as these profits are not unrestricted or driven by the activities of a monopoly or cartel. Islam deems profit, rather than interest, to be closer to its sense of morality and equity because earning profit inherently involves sharing risks and rewards. Profitmaking addresses the Islamic ideals of social justice because both the entrepreneur and the lender bear the risk of the investment.

The most common forms of Islamic “lending” are *mudaraba*, *murabaha*, and *musharaka* (box 2). Under a *mudaraba* contract the financier provides the capital and the entrepreneur the labor and expertise. Profits and losses are shared at a predetermined rate. *Murabaha* is a common instrument for short-term financing based on the conventional concept of purchase finance or cost plus markup sales. (These two concepts are described in more detail in the section on country experiences, particularly in the section on Yemen.) *Musharaka* is an equity participation contract in which two or more partners contribute to the capital and expertise of a project. Profits and losses are shared according to the amounts of capital invested. These transactions have traditionally been used for medium- and long-term investments.

In Yemen all microfinance programs except one use Islamic finance techniques. Overall the experience has been good. This approach increases the operational costs of

**Box 2. Applying Islamic finance to microfinance**

*Mudaraba.* Under this model the microentrepreneur and the microfinance program are partners, with the program investing the money and the entrepreneur the labor and expertise. Profit is shared according to an agreed percentage, though the profit is unknown. In effect, the microfinance program takes equity in the microenterprise through the loan: initially the program may own 100 percent of the shares and so would be entitled to 100 percent of the profit. But as each loan installment is paid, the entrepreneur “buys back” the shares. Hence with each installment the entrepreneur earns more profit and the program less.

From a microfinance perspective this model has several drawbacks, the most important being the uncertainty of the profit. But profits fluctuate even in the best microfinance programs. A second drawback is the burden of loan administration and monitoring. Even if the profit is known, the borrower has to repay a different amount each period (and the loan officer has to collect different amounts). The lack of simplicity—relative to equal installments—confuses borrowers and loan officers. The margin of error is considerable given that a single loan officer often manages 100–200 borrowers.

*Murabaha.* This model is similar to trade finance in the context of working capital loans and leasing in the context of investment capital loans. The microfinance program literally buys the goods and resells them to the entrepreneur for the cost of the goods plus a markup for administrative costs. The borrower repays in equal installments. This model is much easier for borrowers to understand and for microfinance programs to administer. Moreover, the concept automatically provides collateral for the program because the program owns the goods until the last installment is paid.

<i>Issue</i>	<i>Mudaraba (profit sharing)</i>	<i>Murabaha (buy-resell)</i>
Most applicable for	Fixed assets	Working and investment capital
Cost to borrower	Higher because of higher profit share of program due to higher risk	Lower
Initial borrower acceptance	Higher	Lower because model is similar to fixed interest rates
Risk to borrower	Lower if no predetermined minimum profit is allowed	Higher
Risk to program	Higher if no predetermined minimum profit is allowed	Lower
Administrative costs	High given the complexity of the repayment schedule	Initially high because of the high volume of buy-resell transactions. Administration and monitoring are simple, however, due to equal installments
Enforcement	Difficult because of possible lack of transparency in determining profit	Easy; program owns goods until last installment is paid

Source: Dhumale and Sapcanin 1998.

making loans, and some borrowers—who are savvy entrepreneurs all over the world—have started to ask for commercial loans. Still, the provision of financial services based on Islamic principles meets a demand unmet by other programs.

Some countries have had large-scale Islamic finance programs for quite some time. These programs were not included in the survey conducted for this report because of a lack of complete and reliable data. Although these programs often have a low profile, they offer valuable services in a professional man-

ner. A good example is Lebanon’s Monetary Housing Institution, a private organization with about 5,000 active clients. Half the clients have emergency loans of less than \$1,000 with a six-month maturity; the other half have working capital loans of less than \$10,000 for businesses.

*Lending programs for very small businesses are emerging*

Several programs in the region—the Cooperative Housing Finance (CHF) program in Jordan and Lebanon, the U.S. Agency for Inter-

Profits will encourage banks to continue lending to small businesses

national Development (USAID) program in the West Bank and Gaza, and the International Finance Corporation–World Bank–Dutch government project in the West Bank and Gaza—are applying lessons from microfinance best practices to small business finance. These lessons include:

- Decentralizing decisionmaking on loans.
- Evaluating loan requests based on cash flow and character rather than assets and documents.
- Developing client relationships and intimate industry knowledge while implementing loan screening and monitoring systems as well as client tracking systems.
- Making loan officers responsible for granting loans as well as collecting repayments—and paying them based on their performance in these areas.
- Setting interest rates and fees that reflect costs and risks.

All these programs are being implemented by private commercial banks. In Jordan and Lebanon only working capital loans are offered to small businesses, while in the West Bank and Gaza both working capital and investment capital loans are offered. One bank offers investment capital loans only after a small business has established a good track record of repaying working capital loans. Repayment rates are high, and some banks are already making profits from this type of lending. Profits will provide a key incentive for banks to continue this type of lending after donors have departed. One bank has set up a new legal subsidiary to specialize in this type of lending, while another bank is doing so.

#### *Unemployment lending programs are big players*

The survey conducted for this report sought to analyze microfinance developments in the Middle East and North Africa, with microfinance defined the traditional way as the provision of financial services to the entrepreneurial poor. As noted, the region's microfinance industry uses a narrow definition of microfinance, mainly offering credit: small

working capital loans that usually increase with timely repayment.

But many of the programs covered by the survey do not fit the traditional definition of microfinance. Instead they offer small investment capital loans to the unemployed. The mandate of these programs is to reduce unemployment—not necessarily to provide sustainable financial services to the poor. These programs are referred to as unemployment lending programs.

In some Middle Eastern and North African countries these programs have more active clients than do microfinance programs and have much larger outstanding loan portfolios. In addition, they have received far more funding from governments and donors. Data on these programs were available for Egypt, Jordan, Lebanon, Tunisia, and the West Bank and Gaza but not for Morocco and Yemen. Yemen had one such program but it is being closed. In Morocco data were not available. Elsewhere, most of these programs lack appropriate information systems and were unable to provide basic information. Hence data are of poor quality and should be interpreted as indicators rather than hard facts.

Although they vary between and within countries, in general the investment capital loans provided by these programs are small relative to the investment capital loans made by commercial banks. At the end of 1999 the average outstanding balance of microfinance programs was \$460; the average for unemployment lending programs was \$4,262 (table 2). The maturities of the unemployment loans range from 1 to more than 10 years, with an average of 2–3 years. In most cases a grace period of three months to one year is offered.

Unemployment lending programs share several key characteristics:

- The target group is unemployed workers, young people, or both, and the business activities funded are usually new activities.
- Most loans go to men.
- Interest rates are subsidized.
- Loans are often combined with compulsory training or technical assistance.
- Programs are managed by large govern-

**Table 2. Microfinance programs and unemployment lending programs in the Middle East and North Africa, 1999**

Indicator	Egypt	Jordan	Lebanon	Morocco	Tunisia	West Bank and Gaza	Yemen	Total or average
Number of microfinance programs	15	8	5	7	6	3	4	48
Number of unemployment programs	1	3	11	..	5	5	0	25
Number of active microfinance clients	90,897	17,777	4,438	42,571	3,251	7,264	2,619	168,817
Number of active unemployment clients	40,000	5,320	6,330	..	22,575	1,537	—	75,762
Outstanding microfinance portfolio (U.S. dollars)	47,629,087	17,599,098	2,018,103	6,008,185	1,808,181	2,136,267	474,380	77,673,301
Outstanding unemployment portfolio (U.S. dollars)	200,000,000	25,009,450	8,676,971	..	85,000,000	4,193,339	—	322,879,760
Average outstanding balance of microfinance loans (U.S. dollars)	524	990	455	141	556	294	220	460
Average outstanding balance of unemployment loans (U.S. dollars)	5,000	4,701	1,371	..	3,765	2,728	—	4,262
Female microfinance clients (percent)	25	47	95	76	64	100	26	46
Female unemployment clients (percent)	20	25	23	..	20	44	—	21

.. Not available; — Not applicable

Source: World Bank survey of microfinance institutions.

mental or quasi-governmental organizations or by small charitable NGOs.

- Programs often lack appropriate information and management systems.

As a result of these characteristics, most programs have low repayment rates and high loan losses.

## Survey findings

The survey conducted for this report focused on the growth, institutional forms, clients, and sustainability of the region's microfinance institutions.

### Growth

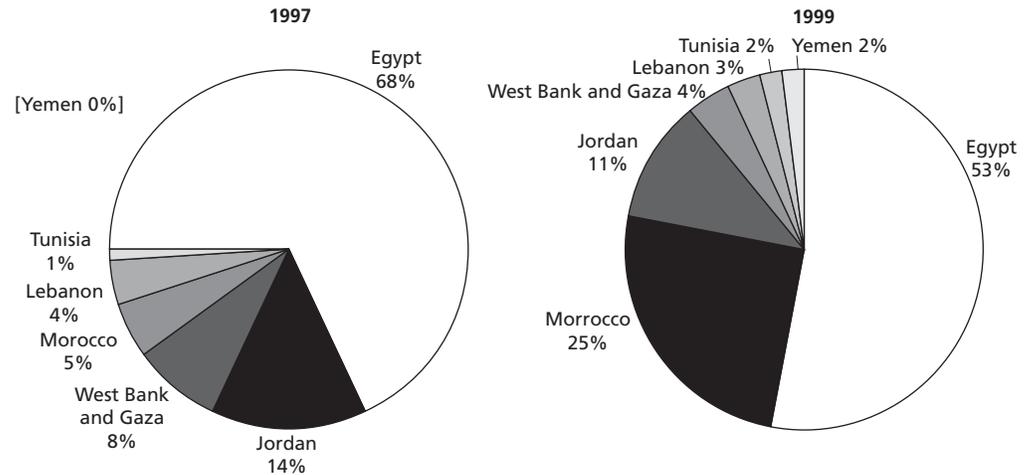
The microfinance industry in the Middle East and North Africa almost doubled between the end of 1997 and the end of 1999, from 90,000 active clients to almost 170,000. Egypt remains the leader in the region but has lost market share: from 68 percent of active clients in 1997 to 53 percent in 1999 (figure 2). While Jordan was in second place in 1997,

that position has been taken over by Morocco, which saw the number of clients jump from just over 4,000 in 1997 to more than 42,000 in 1999 (figure 3). Hence it is not surprising that Morocco was the main contributor to the growth of microfinance in the region.

In some countries, however, the microfinance industry hardly grew or even shrank. In Lebanon and the West Bank and Gaza this was mainly due to the second generation issues described above. Key players underwent consolidation and restructuring but are now poised for rapid growth. Tunisia's industry hardly grew because local NGOs (associations) were awaiting the passage of the 1999 law on microcredit.

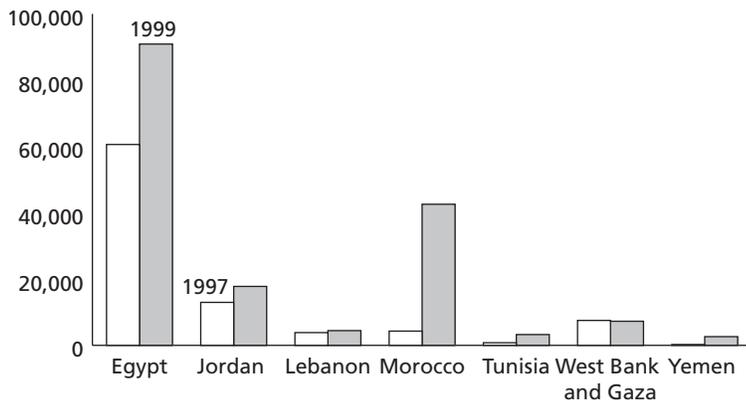
The outstanding loan portfolio in the Middle East and North Africa grew from \$44.6 million in 1997 to \$77.7 million in 1999. But the average outstanding loan balance dropped from \$495 in 1997 to \$460 in 1999—mainly because of the entry and rapid growth of new programs. A microfinance program usu-

**Figure 2. Share of active microfinance clients in the Middle East and North Africa by country, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

**Figure 3. Number of active microfinance clients in the Middle East and North Africa by country, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

ally starts with small initial loans, and only with timely repayment do borrowers get larger loans. With many new clients the average outstanding balance could fall. Hence it is not surprising that Morocco, which had the most new clients, also had the lowest average outstanding balance (\$141).

**Institutional forms**

Microfinance providers in the region take one of six institutional forms:

- Local NGOs, including foundations (as in Egypt), cooperatives (Yemen), charitable

groups (Lebanon), and associations (Morocco, Tunisia).

- International NGOs, which often do not have to comply with local NGO laws (as in Tunisia, where an international NGO is exempt from the 1999 law on microcredit).
- Banks. Only banks that engage in microfinance on a voluntary basis without facing government pressure or serving as a conduit for government lending programs are included in this category. Banks that channel funds under government pressure or mandate are included in the government category (below).
- Private companies—microfinance programs registered or reregistered (see below) as private shareholding companies.
- Government agencies, including quasi-governmental agencies such as social funds, with the determining factor being whether they are under government control or pressure.
- United Nations agencies such as the UN Relief and Works Agency (UNRWA) in Jordan, Lebanon, and the West Bank and Gaza and the UN Children’s Fund (UNICEF).

In 1999 more than 70 percent of the region’s active microfinance clients were

served by local NGOs (figure 4)—about the same as in 1997. Egypt’s National Bank for Development is still the only bank in the region that engages in microfinance on a large scale. Morocco’s Fondation Banque Populaire has started microlending, however. Although more banks have become active, they are classified under very small business programs because they have different target groups than do traditional microfinance programs (see below). The banks engaged in this type of lending are fully private, and it is promising that the private sector is becoming involved in microfinance and very small business finance.

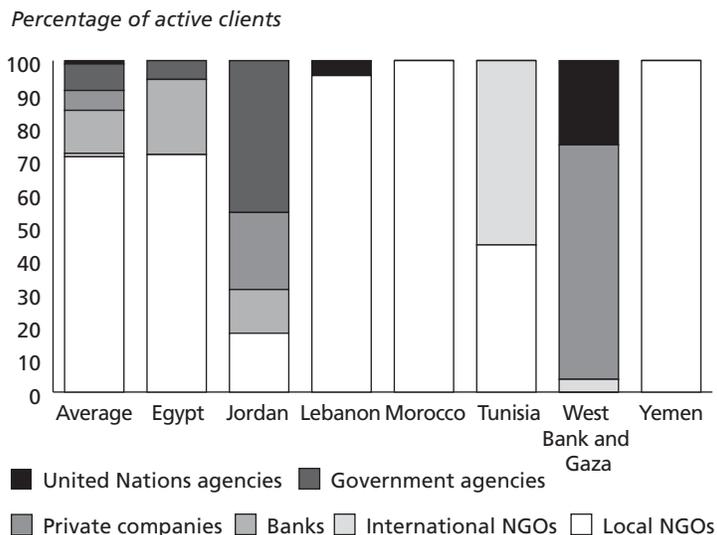
The same is true for the emergence of private companies. In Jordan two private companies have been established solely to engage in profitable and sustainable microfinance (see figure 4). In Jordan and the West Bank and Gaza two former Save the Children programs—the Jordanian Microfund for Women and Palestine for Credit and Development (FATEN)—were transformed into privately owned and managed microfinance companies. Both are market leaders in their countries.

There are good reasons for private companies to provide microfinance. Doing so helps avoid excessive government interference. Moreover, private companies have far more transparent governance than, say, NGOs. The shareholders of a private company are accountable and liable for achieving the company’s objectives—the board members of an NGO are not.

It is difficult if not impossible for NGOs to borrow money from banks for lending to microentrepreneurs. Banks are wary of extending such loans because they cannot sue NGOs in cases of default. But they can sue private companies. Moreover, private companies can make profits, which are crucial for sustainability and help build capital. NGOs often cannot earn profits. Most important, private companies have a business orientation—a condition for sustainable microfinance.

Many microfinance programs in the Middle East and North Africa are part of larger,

**Figure 4. Institutional form of microfinance providers in the Middle East and North Africa, 1999**



Source: World Bank survey of microfinance institutions.

more social and charitable organizations, such as the former Save the Children programs in Jordan, Lebanon, and the West Bank and Gaza or the UNRWA microfinance programs. Although these institutional forms may be appropriate in the early stages of a microfinance program, they are likely to hinder the program’s development as a financial intermediary. The corporate cultures in the parent program and the microfinance program may differ or even conflict (between giving grants and offering loans). The parent program’s managerial and administrative systems often do not allow best practices appropriate for microfinance, such as loan portfolio management based on aging of arrears, cash accounting, loan enforcement, performance-based incentives, and a general business attitude. Finally, it is difficult for a microfinance program based in a larger, socially oriented organization to raise commercial funds—whether taking deposits or borrowing in local capital markets.

Hence spinning off a microfinance program from its parent organization may be the only way to achieve financial and institutional sustainability. That is what the Save the Children programs in Jordan, Lebanon, and the West Bank and Gaza did: all three were

### Box 3. Spinning off for sustainability—the case of Save the Children

The joint provision of social services and microfinance by the same organization usually does not work. Often the objectives, culture, and managerial and operational systems of the larger social program clash with those of the microfinance program. For instance, a socially oriented parent organization may have a charitable outlook, give grants to the needy, employ social workers and rely on volunteers, and use a cash-based budget system. But a successful microfinance program needs a business orientation, business-oriented loan officers paid based on performance, and financially oriented administrative and budget systems. It also needs a governance structure that provides strategic direction, ideas, and solutions to ensure the longevity of the program.

These clashing objectives and operations may result in institutional schizophrenia that permeates the entire organization. On the one hand, the organization provides grants to the poor. On the other, it provides loans for which repayment is strictly enforced. The clients of the social program are beneficiaries, while the clients of the microfinance program are clients who buy a service they value. A good social worker is not necessarily a good loan officer, and vice versa. The confusion of staff, donors, and clients is often reflected in poor repayment rates and high delinquencies—undermining the sustainability of the microfinance program. Thus programs that provide both social and financial services should manage their programs separately, with different administrative procedures, recruitment, staffing, and sometimes even names.

Three former Save the Children programs in Jordan (the Jordanian Women's Development Society), Lebanon (Al Majmoua), and the West Bank and Gaza (Palestine for Credit and Development, or FATEN) show that separating programs may not be enough to ensure financial and institutional sustainability. Instead, spinning off the programs was a prerequisite

*Source:* Dhumale, Sapcanin, and Brandsma 1999.

for their survival. Financial sustainability could only be achieved if the programs were able to directly access commercial funds. This was not possible under Save the Children, an international NGO, so the programs had to become locally owned and managed entities. More important, however, was institutional sustainability. Under Save the Children the three microfinance programs were not institutions. Crucial administrative and managerial skills—treasury and fund management, personnel management—were lacking. The legal separation of the programs created a tremendous sense of local ownership, pride, responsibility, and accountability essential for institutional sustainability. Staff are now able to shape the future of their institutions.

Spinning off proved to be a long and rather difficult process. Among the daunting issues were the timing of the spin-off, legal decisions on the legal and organizational forms of the new entities, funding issues such as transferring donor agreements, ownership and governance issues such as selecting boards of directors and determining appropriate roles for different levels of governance, staffing issues and changing or building corporate cultures, and psychological issues relating to the “divorce” from the parent institution.

Spinning off is a strategic choice—one that makes sense only if it is done in the context of another strategic choice: achieving full sustainability. Because managing a program is not the same as managing an institution, the main lesson from the Save the Children spin-offs may be that if full sustainability is the prime objective, it may be best to set up a microfinance program as an independent institution right from the start. In Jordan, for example, USAID has decided to support only programs that are legally independent entities. In some cases this requires programs applying for USAID support to set up separate legal entities to own and manage the program.

spun off into locally owned and managed organizations (box 3).

Government agencies play a small role in microfinance. Only Egypt and Jordan have government programs: Community Devel-

opment Microfinance under the Social Fund for Development in Egypt and the National Aid Fund in Jordan. Neither program is performing well. The absence of government programs has not hindered the development

of the region’s microfinance industry. Government agencies play a much bigger role in unemployment lending, serving 86 percent of the beneficiaries of these programs.

**Clients**

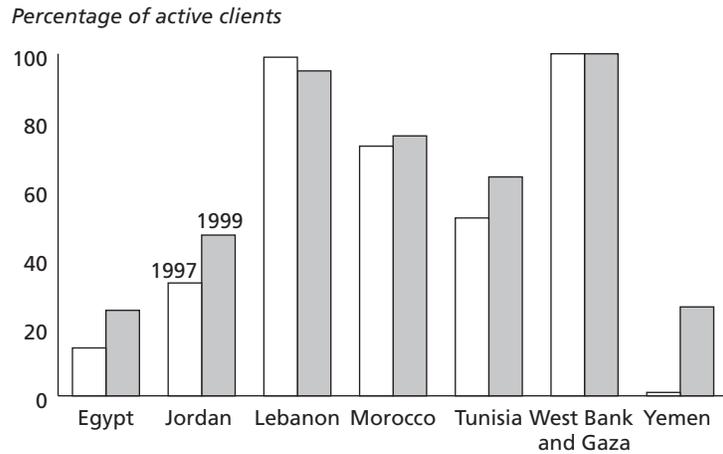
As noted, microfinance institutions in the Middle East and North Africa take a narrow approach, offering only credit for business activities. Among the region’s nearly 170,000 active clients in 1999, fewer than 2,000 were savers—and all were women. Many poor people need savings and deposit services, especially women, so a large part of the poor is excluded. Given this imbalance, the following analysis focuses on borrowers.

The share of female borrowers grew from 31 percent of active clients in 1997 to 46 percent in 1999—an increase of about 50,000 women. As with microfinance clients generally, Morocco was the main contributor to this growth. Its Zakoura program targets women exclusively, while AlAmana serves both men and women. Together these programs increased their female client base by more than 21,000. New entrants that target women exclusively were another reason for the growth.

Egypt has the smallest share of female borrowers (figure 5). Recognizing this shortcoming, some of Egypt’s successful microfinance institutions have started targeting women with savings and credit services. Many of the potential clients are in rural areas. Yemen has also increased its share of female borrowers with the entry of a new program that targets women with savings and credit services.

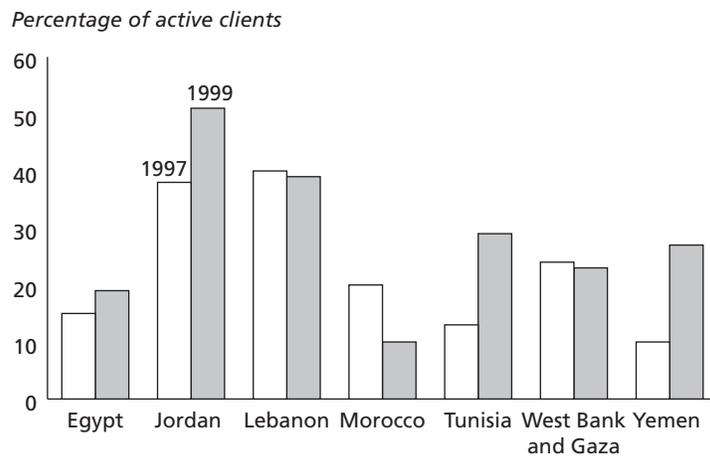
The share of borrowers in rural areas rose from 18 percent in 1997 to 21 percent in 1999. This small increase is not surprising because many microfinance institutions start in densely populated urban areas, moving to rural areas only when they have achieved scale and become more efficient. Egypt and Morocco have the region’s smallest shares of rural borrowers—in Morocco the share dropped from 20 to 10 percent (figure 6).

**Figure 5. Share of female microfinance borrowers in the Middle East and North Africa by country, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

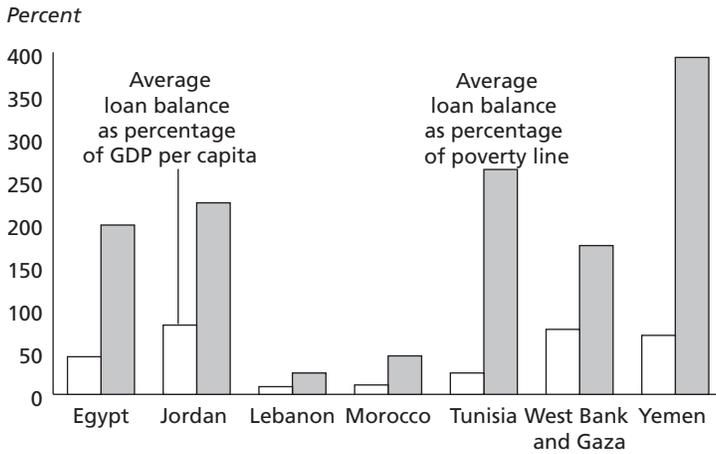
**Figure 6. Share of rural microfinance borrowers in the Middle East and North Africa by country, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

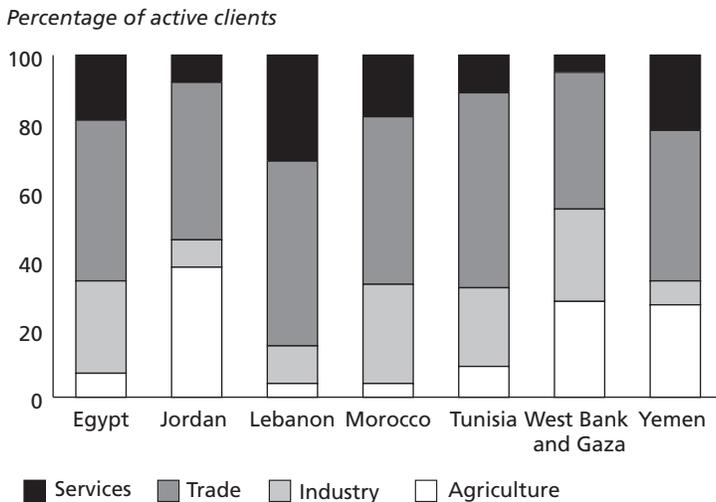
To proxy the poverty of borrowers, we compared the average outstanding loan balance in a country with that country’s GDP per capita and income poverty line (figure 7). The reasoning is that the poorer people are, the smaller will be the loans they take. This approach follows that used by best practice microfinance programs, which look at the household income of borrowers (not the project for which the loan is intended) to determine repayment capacity and so loan size. Programs that do not follow best practices—such as unemployment lending pro-

**Figure 7. Proxies for poverty among microfinance borrowers in the Middle East and North Africa, 1999**



Source: World Bank survey of microfinance institutions.

**Figure 8. Uses of microfinance loans in the Middle East and North Africa, 1999**



Source: World Bank survey of microfinance institutions.

grams—do not pay attention to the household’s repayment capacity and often give overly large loans. This is irresponsible because it not only puts the borrower at a higher risk of increased poverty, it also jeopardizes the existence of the program because of high arrears and loan losses.

Lebanon, Morocco, and the West Bank and Gaza have the deepest targeting: their microfinance clients are poorest relative to those in other countries. This was also the case in 1997. Not surprisingly, these countries also have the largest shares of female borrowers,

who around the world are among the poorest. Many programs targeting women use group lending, in which women in groups take individual loans but guarantee each other. Jordan and Yemen, with average loan balances close to average GDP per capita, risk not targeting the poor.

Finally, what are loans used for? Many microfinance borrowers are active in trade (figure 8). Again, the view that trade “does not add value” is a development bias. Ahmed, an entrepreneur in Yemen, is illustrative. He lives in a slum area outside Hodeidah city and runs a small grocery store that would be classified as retail-trade. His clients appreciate his services. The location of his shop saves them time and money (it takes an hour to walk to town to buy goods or costs 100 rials to take the minibus). In addition, Ahmed splits the goods bought into small quantities. Poor people cannot afford to buy a gallon of cooking oil or a kilogram of sugar—but they can afford a few ounces or 200 grams. According to Ahmed’s clients, his business adds value.

*Sustainability*

Of the 60 microfinance programs included in the 1997 survey, 2 were fully sustainable and 8 were well on their way to that goal. Ten programs were very small but had as their main objective the sustainable provision of microfinance. Most of the remaining programs were in bad shape and not following best practices. The authors of *Making Microfinance Work in the Middle East and North Africa* optimistically assumed that perhaps 20 of those programs would change their approach. That proved not to be the case.

Together the 2 sustainable programs and the 8 that were well on their way served about 80 percent of active clients. This was important because clients want continued access, and this was expected to be available for this 80 percent of clients. Even though many other programs were wasting donor funds and many of their clients were expected to lose continued access, the authors were not especially worried because most clients were served by best practice programs.

This is still true today: most of the region's active microfinance clients are served by programs that follow best practices (table 3). There are fewer programs labeled microfinance than in 1997, mainly because in 1999 some programs were reclassified as unemployment lending programs. This is because—despite their claims to the contrary—they are not engaged in microfinance.

The 10 programs that in 1997 were fully sustainable or well on their way now serve 63 percent of the region's active clients. The 10 programs that were small in 1997 but sought full sustainability serve 20 percent of the market (almost 33,000 clients), up from less than 6 percent in 1997. Finally, a few new programs have emerged with full sustainability as an objective. Today they serve only 6 percent of clients, but that share is expected to grow rapidly in the next few years.

### The future of microfinance in the Middle East and North Africa

All the programs surveyed were asked how many active clients they expected to serve within five years—that is, by the end of 2004. Their goals were ambitious: together the programs expect to serve more than 422,000 clients (figure 9). Assuming that new programs will also be established—for instance, in Egypt nine more foundations are being set up using the Alexandria Business Association model—the microfinance industry in the Middle East and North Africa could serve more than 500,000 clients by the end of 2004.

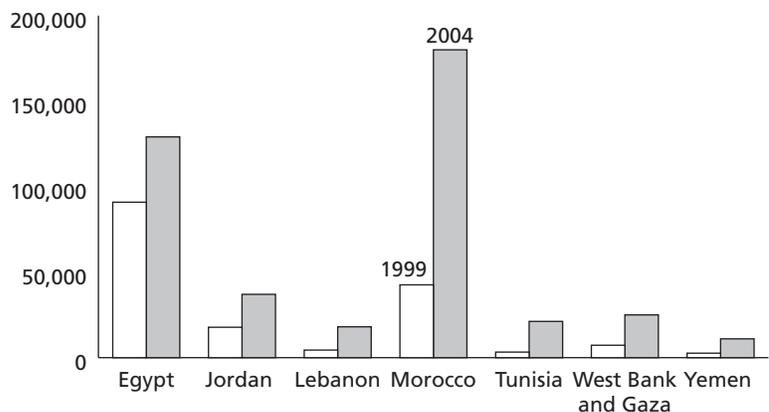
Are these expectations realistic? Maybe not. First, the forecasts for programs in Morocco and Tunisia are unrealistic. As noted, Tunisia's 1999 law on microcredit will likely hamstring its emerging industry. Programs will have trouble building sustainable portfolios because they probably will not be able to cover their costs. They are expected to deplete their capital quickly, causing the industry to shrink.

**Table 3. Number and market share of best practice microfinance institutions in the Middle East and North Africa, 1999**

Country	Number of institutions	Number of best practice institutions	Market share of best practice institutions (percent)
Egypt	17	8	90
Jordan	8	3	36 (66) <sup>a</sup>
Lebanon	5	3	91
Morocco	7	3	90
Tunisia	6	1	55
West Bank and Gaza	3	2	96
Yemen	4	4	100
Total	51	24	88

a. The market share of Jordan's 3 best practice programs increases to 66 percent if the sample excludes the microcredit program of a large government agency that does not implement best practices and in effect gives grants, not loans.  
Source: World Bank survey of microfinance institutions.

**Figure 9. Active microfinance clients in the Middle East and North Africa, 1999 and 2004 (projected)**



Source: World Bank survey of microfinance institutions.

Morocco's leading microfinance programs may have been too optimistic in their projections, possibly because of their dramatic recent growth. They probably reasoned that if they went from 4,000 to more than 42,000 active clients in less than two years (between 1997 and 1999), why should they not grow to 180,000 clients in five years? Morocco's programs are effective and are implementing best practices, but it may take them more than five years to achieve this ambitious goal. Some can be expected to face crises because recent growth may have been too fast. Their organizations and managerial and adminis-

There appears to be a limit to the size and growth of NGOs and foundations that only grant credit

trative systems may have to catch up with the recent growth, and some consolidation and restructuring can be expected—temporarily slowing them down.

A second but much more important reason to expect slower growth is that there appears to be a limit to the size and growth of NGOs and foundations that only grant credit. This point is illustrated by the changing market shares of different types of microfinance institutions. These types are fully sustainable, nearly sustainable, former small and beautiful (programs that in 1997 had few clients but sought full sustainability and have since grown), new small and beautiful (programs set up since 1997 with full sustainability as their objective), and worst practice.

The market share of the leaders—fully sustainable or nearly sustainable programs—has fallen (figure 10). The market share of former small and beautiful programs has increased. They are not small anymore, but they are still beautiful. New small and beautiful programs just started but, based on the growth of the former small and beautiful programs, can be expected to increase market share rapidly. The share of worst practice programs has fallen.

Why did fully sustainable and nearly sustainable programs lose market share? Because

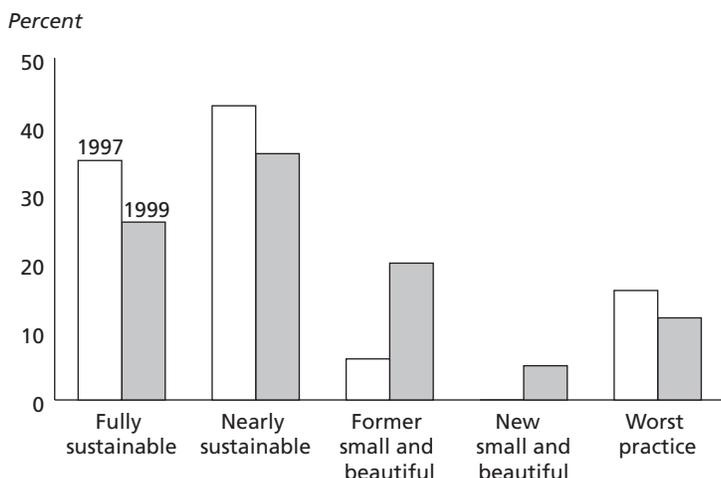
they did not grow as fast as the formerly small but currently sizable programs. The 2 sustainable and 8 nearly sustainable programs saw active clients increase from 71,000 in 1997 to 105,000 in 1999. This is respectable growth of 47 percent but, given the large unmet demand, appears low. Former small and still beautiful programs grew from 5,000 clients in 1997 to 33,000 in 1999—growth of more than 600 percent.

The rather disappointing growth of the 10 market leaders can be explained by a combination of factors. Some underwent restructuring and consolidation as a result of crises. Others seem to be resting on their laurels: they are sustainable and are the darlings of donors but do not seem to have the drive to reach more poor people. Some, especially those operating in small markets, have narrow market niches and serve one target group with one loan product and may have to diversify to grow, targeting other groups of poor people and introducing new financial products.

Finally, limited sources of funds for onlending may be an important reason for the slow growth of the market leaders. Most of the leaders still depend on donor funds, but they do not need to. They could start raising funds for onlending commercially by, for instance, borrowing from banks. Some donors have not been creating incentives for the programs they support to do so. They have also been resting on their laurels.

Some programs have tried to raise funds commercially but have run into legal and regulatory obstacles. In borrowing from a bank for onlending, having the legal form of an NGO can be an impediment because it lacks transparency and accountability. As noted, a bank can be expected to be unwilling to lend to such a legal form, especially if it cannot sue that legal form. Two of the region's ten leading programs have changed legal form, from NGO to private company, in order to borrow commercially. These changes were recent, so it is too early to tell whether these companies will now be able to borrow from banks.

**Figure 10. Market shares of different types of microfinance institutions in the Middle East and North Africa, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

One of the 10 leaders tried to become a bank, which would make sense because as a bank it could take deposits and savings. But the \$30 million in minimum capital required of a bank (in this case in Egypt) was too much of a financial obstacle.

If the region's credit-granting NGOs are to achieve the scale of microfinance institutions in other parts of the world, they will have to raise funds commercially, including taking deposits. As noted, this move will also enable them to move beyond their narrow approach to microfinance. By mobilizing deposits and savings, they will be able to serve thousands more clients.

To raise funds commercially, most current leaders and some emerging leaders will have to change legal form. Policymakers in these countries have to create legal environments appropriate for prudent but growing microfinance. This may be the biggest challenge for the region's microfinance industry over the next few years.

### **Note**

1. This section draws heavily from Dhumale and Sapcanin (1998).



## Microfinance Developments by Country

This section reviews key microfinance developments in each country that participated in the 1999 survey. Unemployment lending and very small business lending programs are also covered for countries where information was available: Egypt, Jordan, Lebanon, Tunisia, and the West Bank and Gaza. Yemen has no unemployment lending or very small business lending programs, and no data were available for Morocco. Again, the quality of the data on unemployment lending programs was not always optimal and should be interpreted with caution.

### Egypt

Egypt leads its Middle Eastern and North African neighbors in microfinance. It has the highest number of active clients: an estimated 91,000 in 1999, with an outstanding portfolio of almost \$48 million—up from 60,000 in 1997 with a portfolio of \$30 million. More important is that most Egyptian microfinance institutions (except the Social Fund for Development's community development program) follow best practices. They have excellent loan portfolios and loan portfolio management systems, solid and loyal customers (as reflected in high repayment rates and high retention rates), and financial management and accounting practices that may be better and more transparent than those in Egypt's public banks. As a result several of Egypt's microfinance institutions are fully sustainable, and others are close to achieving that goal.

The most successful programs are the Alexandria Business Association, which is

the market leader, and the National Bank for Development program, which has almost as many active clients as the Alexandria Business Association. The Alexandria Business Association is known around the world as a best practice model of efficiency: its operational cost of making a loan is 8 percent of every Egyptian pound lent, one of the lowest rates in the world. With help from USAID, the Alexandria Business Association's model has been replicated around Egypt. Five new foundations have been set up since the association started, with the foundation in Cairo being the most successful and taking the third market position. (The five foundations are the Egyptian Small Enterprise Development Foundation in Cairo, the Small Enterprise Development Association of Port Said, the Assiut Businessmen Association, the Skarkeya Business Association for Community Development, and the Dakahleya Business Association for Investors and Community Development.)

The National Bank for Development is a private commercial bank that has built a sustainable and profitable microcredit portfolio. The program is implemented through 43 branches, with 2 branches fully dedicated to microfinance. By the end of 1999 the program accounted for less than 5 percent of the bank's lending—but contributed more than 30 percent of its profit.

### *Constraints to outreach, growth, and market penetration*

Egypt's microfinance industry has several characteristics that appear to limit its continued growth:

Most Egyptian microfinance institutions follow best practices

Egypt's  
microfinance  
institutions are  
essentially a  
network of  
successful  
but scattered  
initiatives

- *Market penetration is low.* Egypt harbors huge potential demand for microfinance, yet its market penetration rate is among the lowest in the region. Less than 5 percent of the poor—fewer than 100,000 people—receive financial services. The industry could support 2–3 million clients.
- *Microfinance is narrowly defined.* Most of Egypt's microfinance programs offer only credit for business activities. As a result thousands of potential beneficiaries are excluded: those needing finance for other purposes (such as credit for consumption or emergencies) and those needing savings, deposit, and insurance services. Egypt's NGOs and foundations are not allowed to collect savings and deposits.
- *Most clients live in urban areas.* More than 80 percent of Egypt's microfinance clients live in urban areas such as Cairo and capital cities of other governorates (Alexandria, Assiut, Sharkeya, Dakahleya). This is not surprising: although in relative terms poverty is higher in rural areas, in absolute terms most poor people live in urban or semiurban areas. In addition, it is more advantageous for a microfinance institution to start in urban areas because it will be able to build up a large volume of clients quickly and so benefit from economies of scale. These benefits can then be passed on to clients.
- *Most clients are male.* Three-quarters of Egypt's microfinance clients are male. The main reason may be that Egyptian microfinance institutions mainly offer credit for businesses—a financial service that many women, especially the poorest, may not need. Another reason is that most of Egypt's microfinance programs do not target women exclusively.
- *Growth seems to have leveled off.* The most successful programs have a stable client base, but in recent years did not grow much beyond that base.

Experts are puzzled that Egypt, despite the presence of highly successful programs, has such low market penetration. Microfinance professionals often ponder why Egypt

does not have its own version of a BancoSol or Bank Rakyat Indonesia. Bolivia's BancoSol is a well-known example of a microfinance NGO that became a licensed microfinance commercial bank. In terms of clients, it is Bolivia's largest bank. Bank Rakyat Indonesia is a state-owned bank with millions of microsavers and borrowers and more than 3,600 branches. Because of its high-quality portfolio, it is one of the few banks in East Asia that was not affected by the region's recent financial crisis.

Although most of Egypt's microfinance institutions have impressive track records, they are essentially a network of successful but scattered initiatives. The main donor for these programs, USAID, has recognized this and has started implementing an \$85 million follow-on program, establishing 9–15 more foundations. But representatives of Egypt's successful microfinance institutions and of USAID acknowledge that the most this initiative will achieve is a larger network of successful but scattered initiatives. Moreover, considering how much time and money was spent building the initial network of successful microfinance institutions, it remains to be seen whether developing new programs will be cost-effective and whether it will contribute to a substantial and sustainable increase in market penetration.

Some of Egypt's most successful microfinance institutions may be able to take deposits in the future. That would make them less dependent on donors and enable them to provide a financial service that is needed but not offered. It would also enable them to grow. The only way for these institutions to take deposits would be to transform into commercial banks. But the minimum capital requirement for a commercial bank in Egypt (\$30 million) is too steep for a microfinance institution.

Governments elsewhere have created special legal forms and lowered minimum capital requirements for microfinance intermediaries that take deposits. They are either self-supervised or supervised by a small autonomous unit of microfinance

experts. The Egyptian government should consider creating a special legal form for deposit-taking microfinance institutions. This move would contribute to the development of the microfinance industry, though not as much as well-designed initiatives with the formal financial sector.

### *A suggestion for jumpstarting development*

The most expensive and time-consuming part of efforts to reach hundreds of thousands of microfinance clients in Egypt (including those in rural and remote areas) is the investment in building up physical and administrative infrastructure—that is, a branch network. In addition, hundreds of millions of dollars are needed for onlending in order to reach hundreds of thousands of clients. Donor funds are abundant in Egypt, which helps explain why its successful microfinance programs have not had the drive or the desire to become commercially funded microfinance institutions. But donors are unlikely to be willing or able to foot the bill for the funding gap, which is estimated to be at least \$0.5 billion—if not \$1 billion.

If Egypt is to jumpstart microfinance development and offer financial services to most poor people cost-effectively and sustainably, the formal financial sector must get involved. The formal financial sector has an administrative and physical infrastructure and is a ready source of funds for onlending. In terms of potential outreach (measured in number of branches), the postal savings network and PBDAC have the greatest, most immediate potential. Both organizations also have a ready supply of savings and deposits for onlending.

But it is difficult if not impossible to transform a state-owned entity into a sustainable microfinance intermediary. The well-intentioned objective of state-owned (development) finance institutions—reaching the neediest people—is often subjected to political influences. Politicized mandates place undue emphasis on credit outflows instead of loan recovery. Poor lending practices (such as weak borrower selection criteria, little or

no monitoring, and subsidized interest rates) weaken state-owned institutions financially and make them forever dependent on government or donor funds.

The following factors will make the difference between a successful transformation and a failed one:

- A stable macroeconomic environment.
- Strong leaders to steer reforms, backed by unwavering political support.
- Considerable financial and human capital support from the government and external agencies.
- Liberal financial sector policy that allows banks to design their own products and price them according to cost recovery principles.
- Complete operational autonomy, with no government mandates on lending targets or population groups.
- Large investment in strengthening staff through training, merit-based recruitment, and performance incentives.
- Clear and transparent financial reporting and accountability (CGAP 1997b).

Two of these elements are especially crucial: strong political support and considerable financial and human capital support. Success is most likely if the transformation occurs within the broader context of devolving the government's control of the financial sector. Experience elsewhere shows that political opposition to reforming state-owned development banks, particularly in areas such as removing interest rate subsidies and rigid targeting of certain population groups, can prove insurmountable.

## **Jordan**

Although Jordan's role as the region's second largest provider of microfinance has been overtaken by Morocco, Jordan's industry remains active—with eight microfinance programs, three unemployment lending programs, and one Islamic lending program. New programs implemented using best practices show promise for the industry's future development.

If Egypt is to jumpstart microfinance development, the formal financial sector must get involved

The future of Jordan's microfinance industry looks promising

### Microfinance

Jordan's microfinance industry grew about 40 percent between 1997 and 1999, from almost 13,000 active borrowers to almost 18,000 (figure 11). The outstanding loan portfolio jumped from \$11.4 million to \$17.6 million. The average outstanding loan balance dropped slightly, probably due to the entry of three new players, all funded by USAID and implementing best practices. Being young programs and relatively new to the business, they have started with small initial loans to enable clients to build up track records. Almost half the clients are female, and a similar share lives in rural areas.

The largest microfinance player in Jordan is a government organization that does not target the entrepreneurial poor but rather the destitute poor, the handicapped, and other marginalized groups. The organization's repayment rate is the lowest in the country because repayment is not routinely enforced and because many borrowers should not have received loans in the first place, as they are not creditworthy or are too poor to benefit from loans. Some borrowers may be willing but often are not able to pay, and having a loan puts them in debt—possibly increasing poverty. Although the program targets the poorest, its average outstanding loan balance is one of the highest of Jordan's eight microfinance

programs. This only increases the likelihood of nonpayment. Many of the organization's clients should have been given grants (for social reasons) or would have benefited from savings services. Given the program's fundamental flaws, it is no surprise that it expects to see a drop in active clients over the next few years.

Aside from this program, Jordan's largest program is the Microfund for Women. Like its cousin in the West Bank and Gaza, FATEN, the program did not grow in recent years for two reasons. First, it spun off from its parent organization, Save the Children, into a locally managed and governed NGO—a necessary step for financial and institutional sustainability. Second, it had to deal with fraud that occurred because of rapid early growth. The fund emerged from this experience stronger and wiser and is well on its way to sustainability and increased outreach.

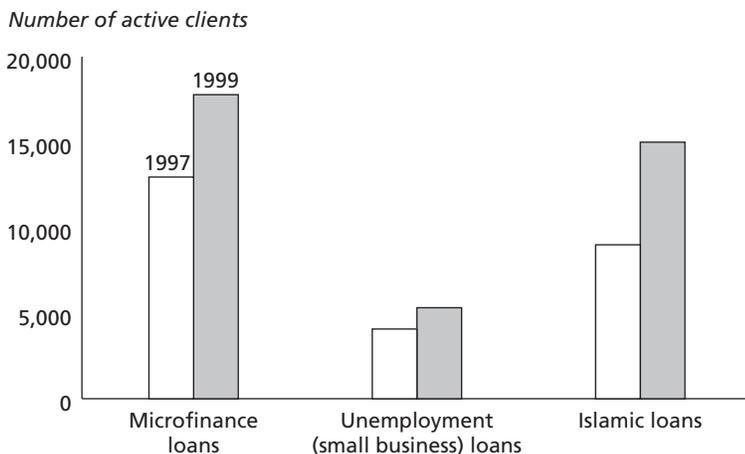
Jordan has several new programs, all funded and assisted by USAID and implementing best practices, with potential for sustainability and growth. It is hoped that USAID will have learned from recent experiences in Jordan and other Middle Eastern and North African countries, and not only emphasize growth targets but, more important, institutional development. It is encouraging that USAID helped set up these programs as separate, independent legal entities, which will contribute to their institutional development.

The future of Jordan's microfinance industry looks promising, with one experienced best practice player and several runners-up. These programs together expect to serve more than 35,000 active clients by 2004. Even if fewer clients are reached—which may be advisable given the risks of rapid growth—these programs are poised for sustainability and outreach.

### Unemployment and very small business lending

Jordan has three programs with characteristics of unemployment lending programs: the large Development Employment Fund, a quasi-governmental organization; the pro-

**Figure 11. Microfinance and other lending in Jordan, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

gram of the Industrial Development Bank; and the small UNRWA program. Although the Development Employment Fund also acts as a wholesale funder of microfinance programs, providing loans to NGOs and other organizations for onlending to microentrepreneurs, only its direct lending program is considered here. Despite the willingness of the fund's managers to change and restructure, Jordanian politicians have been unwilling to commit to such a restructuring.

The Industrial Development Bank's program is also mixed, with some characteristics of an unemployment lending program as well as a small enterprise lending program. The program is shrinking.

Together Jordan's three unemployment lending programs have about 5,500 active clients and an outstanding loan portfolio of almost \$25 million. Most clients are male.

*Islamic finance*

A large player in Jordan's microfinance market that was not included in the 1997 World Bank survey is the Orphans' Fund Management and Development Association. It appears to be set up along the lines of Lebanon's Monetary Housing Institute, making working and investment capital loans using Islamic finance principles and making emergency and consumer loans. It claims 15,000 active clients and a loan portfolio of \$25 million.

**Lebanon**

At first glance, Lebanon's microfinance industry appears crowded, with more than 19 programs. But only 5 offer traditional microfinance; most of the rest are unemployment lenders or very small business lenders.

*Microfinance*

Between 1997 and 1999 the number of active clients in Lebanon's microfinance industry grew 16 percent, from 3,838 to 4,438 (figure 12). The main contributors to this limited growth were a new entrant in the market and the expansion of a village

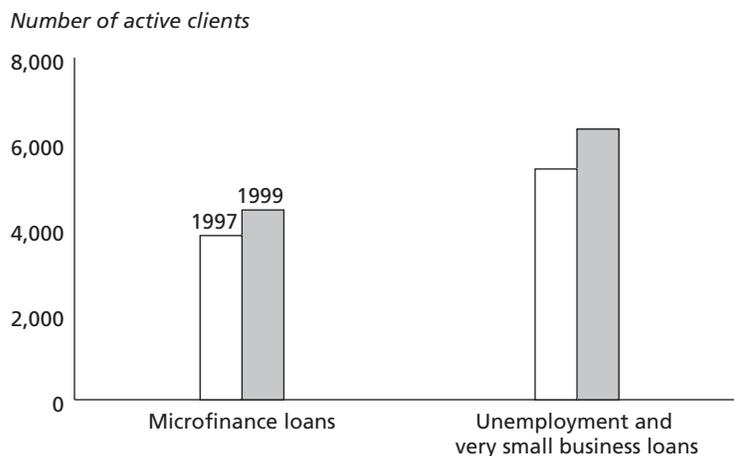
banking program—the only program in Lebanon that also takes savings. The outstanding loan portfolio increased 70 percent, from \$1.2 million to \$2.0 million. This jump mainly occurred because the new entrant offered larger initial loans (about \$400) and because repeat clients of the market leader, Al Majmoua, are getting larger successive loans.

As in 1997, Lebanese microfinance programs have deep outreach, targeting very poor people. The average outstanding loan balance is well below the poverty line. Hence it is not surprising that 95 percent of clients are female, though this is down from 99 percent in 1997. The share of clients taking group loans also fell, from 93 to 82 percent. This is mainly due to the new entrant, which offers individual loans. In addition, to diversify its portfolio Al Majmoua also started offering individual loans to women who thrived in its group lending program. The share of rural borrowers stayed at about 40 percent.

The limited growth in Lebanon's microfinance industry can be explained by the organizational growth curve common to microfinance institutions (see above). Like many new businesses, microfinance institutions often experience rapid growth after a startup period. Soon, however, they need to

Lebanese microfinance programs have deep outreach, targeting very poor people

**Figure 12. Microfinance and other lending in Lebanon, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

As the region's microfinance industry develops, other countries will likely have experiences similar to Lebanon's

adapt and may face a period of slow growth while they restructure and strengthen managerial and administrative systems. Loan products often need to be fine-tuned or redesigned based on feedback from clients, and new products may be introduced. These developments seem to have occurred in Lebanon. Now, however, three of the country's five programs say that they are ready to engage in sustained growth, together aiming to reach more than 18,000 active clients by the end of 2004. As the region's young microfinance industry develops, other Middle Eastern and North African countries will likely have experiences similar to Lebanon's.

#### *Unemployment and very small business lending*

Of Lebanon's 13 unemployment and very small business lending programs, just one focuses on very small businesses. This recently established program follows microfinance best practices and provides working capital loans that increase with continued repayment. It differs from the country's microfinance programs in that it offers larger initial loans and works through a local commercial bank. The 12 unemployment lending programs basically offer investment loans to unemployed, displaced, or other marginalized groups.

There are striking differences between the clients of Lebanon's microfinance programs and the clients of unemployment and very small business lending programs. While most microfinance clients are female, most of the clients of the other programs are male. Most microfinance clients live in urban areas, while most of the clients of the other programs live in rural areas. The reason may be that many unemployment lending programs are funded by donors or other groups that require the programs to lend only in rural areas.

All the unemployment lending programs use subsidized interest rates, although a few offer rates close to—but below—comparable rates charged by commercial banks. In different ways, they all suffer from the same

flaws endemic to unemployment lending programs (see above, in the section on key features of microfinance in the region). As a result their future looks bleak. Their main constraint to growth is not a lack of funds for onlending but a lack of capacity to provide loans efficiently and sustainably.

#### *Islamic finance*

Not covered in the preceding analysis was the Monetary Housing Institution, an organization that provides loans based on Islamic finance principles. The main reason for the exclusion is the unreliability of the data. Still, the institution is a serious player in Lebanon's market for microfinance and very small business finance.

Half of the institution's portfolio of 4,500 borrowers is made up of hassen loans—loans extended without interest to pay for emergencies such as school fees, weddings, funerals, or roof repairs. These loans have a six-month maturity. The other half of the portfolio is for working capital loans under \$10,000 for very small businesses.

The Monetary Housing Institution provides needed services. Unlike unemployment lending programs, it would be able to lend more if it had more funds because it appears to be well organized. Hence the bottleneck is not the institution's capacity to disburse but the lack of funds for onlending. The main sources of funds for onlending are savings and deposits, which are put in a noninterest-bearing bank account.

#### **Morocco**

Morocco's microfinance industry has grown dramatically, from 4,290 active clients in 1997 to more than 42,000 in 1999. Zakoura and Al Amana, two programs funded by USAID and implementing best practices, accounted for more than 80 percent of the growth. The outstanding loan portfolio jumped from \$760,000 to more than \$6 million, while the average outstanding loan balance fell from \$177 to \$141. The share of female borrowers stayed around 75 percent, while the share of

rural borrowers dropped from 20 to 10 percent.

It is surprising that Morocco's two biggest programs saw a decrease in the average outstanding loan balance. This could indicate that the programs have targeted poorer people needing smaller loans. But both programs also have a high percentage of repeat borrowers. Hence the access to larger successive loans that comes with timely repayment may not be a major incentive for microfinance borrowers in Morocco, because they may not need larger loans.

Experience around the world, including dramatic examples in the Middle East and North Africa, shows that programs can grow too fast. A tenfold increase in the number of active clients in less than two years could be dangerous if it is not backed by appropriate organizational development, including internal controls and audit, management information systems, management systems, and branch networks. Overly rapid growth can backfire—as in Jordan and the West Bank and Gaza, where the leading programs experienced massive fraud that caused financial losses and damaged their reputations. Both programs recovered, but the experience set them back two years.

In addition to its two big programs, Morocco has two other microfinance programs that appear promising. The AMSSF Solidarité sans Frontières is implementing best practices and aiming for scale and sustainability. The program of the Fondation Banque Populaire was created to provide sustainable microcredit through the bank's branches. Although the program is only being implemented through 5 branches, implementation through the full network of 14 branches could reach thousands of clients. These clients could also save through the bank's network.

In April 1999 the Moroccan parliament passed a law on microcredit associations. If implemented in an uninformed manner, the law could hinder the development of Morocco's microfinance industry because it sets interest rates and loan ceilings. The law stip-

ulates that by April 2000, all Moroccan institutions providing microcredit were to be acting according to the law.

The following steps are to be taken under the law:

- Organizations that offer services (such as health care or education) in addition to microcredit have to separate microcredit into a microcredit association.
- The associations have to be audited annually.
- The associations have five years to become sustainable, though it is unclear what will happen if they do not.
- The associations are exempt from import and value added taxes for five years, and private persons or organizations making donations to the associations can deduct these donations from their taxable income.
- A Federation of Microcredit Associations will be created.
- The Ministry of Finance will set the maximum nominal interest rate.
- The maximum loan size is 50,000 dirhams (\$500).
- The associations cannot take deposits and savings.

Separating microcredit from other activities and pursuing sustainability are worthwhile objectives. Experience elsewhere shows that providing social or education services together with financial services does not work.

It could be damaging, however, for the Ministry of Finance to set the maximum nominal interest rate. But only the nominal interest rate is mentioned in the law, and associations are not forbidden from charging fees. Hence they may find ways around the nominal interest rate ceiling and may be able to charge effective interest rates that are high enough to cover costs.

The ceiling on loan size does not allow clients of microcredit programs to grow. And because of the ceiling, a major incentive to repay—access to larger loans—is missing. Finally, forbidding associations from taking deposits and savings will exclude many poor people who do not need or want credit.

Overly rapid growth can backfire

Tunisia's law on microcredit could impede the development of a healthy microfinance industry

## Tunisia

With the fewest active clients, Tunisia remains among the region's least active countries in microfinance. The government's influence is quite strong, through regulation of the sector (including a new law on microcredit) and support to programs that provide subsidized loans to the unemployed.

### *Microfinance*

From 780 in 1997, the number of active microfinance borrowers almost quadrupled to 3,251 in 1999. The main contributor to this growth was Enda Inter Arabe, the largest microfinance program in Tunisia implementing best practices.

The outstanding loan portfolio increased almost eightfold, from \$233,000 to more than \$1.8 million. Hence the portfolio grew faster than the number of clients. As a result the average outstanding balance grew from \$298 to \$556. This does not necessarily mean that fewer poor people were targeted. The increase mainly occurred because Enda Inter Arabe has many repeat clients who because of timely repayment get access to larger loans.

The share of female clients increased from 52 percent in 1997 to 64 percent in 1999, mainly because Enda Inter Arabe increased its share of female clients to almost 70 percent. Rural borrowers increased from 13 to 29 percent.

### *The law on microcredit*

The most important—and potentially detrimental—microfinance development in Tunisia was the July 1999 passage of a law on microcredit and microcredit associations. To provide microcredit, an association (a local form of NGO) must be authorized by the Ministry of Finance. Authorization comes only after consideration by an advisory committee composed of representatives of the ministries of finance, interior, social affairs, and economic development, as well as two members with NGO experience.

The law describes the conditions under which associations can provide microcredit. Associations are not allowed to collect sav-

ings from the general public. The law authorizes the Ministry of Finance to set loan ceilings, terms, and conditions (including the interest rate), as well as repayment schedules. The interest rate is fixed at 5 percent a year, and the ceiling is set at 1,000 dinars (\$787). The maximum repayment period is three years. Associations are not allowed to charge fees or commissions and can lend up to 10 percent of their portfolios for consumption loans that have a ceiling of 300 dinars.

The Banque Tunisienne de Solidarité (BTS) is designated as the main source of funds for onlending. The BTS assumes 80 percent of the risk of nonpayment. The BTS is creating a guarantee fund through a compulsory 2 percent contribution on the loans distributed to associations. The law on microcredit also stipulates that associations are responsible for training beneficiaries. International NGOs, like Enda Inter Arabe, are exempt from the law.

The Tunisian government is requiring that an association be established in each of the country's 257 delegations (subprefectures). By the end of 1999 three associations were active, together serving nearly 1,000 clients. By May 2000, 20 associations had been authorized and 9 had received BTS loans for onlending. These loans ranged from 25,000–450,000 dinars.

Tunisia's law is an example of one that could impede the development of a healthy microfinance industry in any country for the following reasons:

- Setting a very low interest rate may make it impossible for microfinance institutions to recover costs. As a result they may quickly deplete their capital. Moreover, borrowers often consider government funds to be grants and so are unlikely to repay them. This is even more likely if a country has a tradition of massive loan forgiveness programs such as those often observed in agriculture.
- Setting loan ceilings will not allow for flexibility and growth. Some borrowers will need bigger loans than others. In addition, access to larger successive loans gives borrowers a key incentive to repay.

Without this incentive, repayment may be low.

- Barring microfinance intermediaries from taking deposits could result in continued dependence on government and donor funds. Moreover, an important target group, the poorest, would be neglected. The poorest are often too poor to benefit from credit because it will put them in debt. The poorest, among them many women, can often be better served with savings and deposit services tailored to their needs.

The microcredit law is well-intended, but it may stifle the innovation and experimentation essential for the development of Tunisia's microfinance industry. Moreover, under the law it will be difficult for microfinance programs to become sustainable—and programs that implement best practices and aim for sustainability may not be able to compete.

### *Unemployment lending*

Tunisia has a long history of government programs intended to create jobs (or reduce unemployment), help disadvantaged groups (such as farmers), or develop certain industrial sectors or geographic areas. These programs have not been very successful. An example is the Fund for the Promotion and Decentralization of Industry (FOPRODI), established in 1974 to encourage new entrepreneurs by providing capital to small and medium-size enterprises, to help decentralize industry away from coastal regions, and to lower unemployment. Loans were to be provided through banks, mainly state-owned.

The fund was wound up in 1997, having largely failed to achieve its objectives. About half of the fund's loans were in default, and the cost per job created was twice the world average (\$11,000 compared with \$5,800). The fund failed for the same reasons as many of the world's well-meaning government initiatives intended to promote employment by providing credit (through public banks or directly):

- Poorly designed incentives.

- Unacceptably high transactions costs for borrowers and lenders.
- Ineffective guarantees.
- A weak bankruptcy law.
- An insufficiently competitive, public sector-dominated banking system.
- Lack of adequate followup by banks of their FOPRODI loans.

Other factors also contributed to the failure, including slow loan processing and disbursement, inadequate staff training, and unduly restrictive bank legislation.

Tunisia's newest and largest unemployment loan provider is the BTS, established in December 1997 with capital of 30 million dinars (\$26 million). Just under two-thirds of the capital is held by the private sector; the rest is held by the public sector. The BTS provides loans to individuals who have a university or vocational diploma or are seeking reintegration in the framework of economic restructuring, who have a profession, and who are willing to set up a business. Loans are generally less than 10,000 dinars but can be increased to 20,000 dinars for borrowers with a university degree. The loan period ranges from six months to seven years with up to a one-year grace period. The interest rate is 5 percent. Loans can only be used for investment in assets, not for working capital. Moreover, borrowers can only buy new equipment. Trade is excluded.

Since its began operating in 1998, the BTS has granted more than 22,000 loans worth a total of 100 million dinars. The average loan dropped from 6,200 dinars in 1998 to 3,700 dinars in 1999. One of every two applications is approved, and the BTS claims a 45-day approval process. Almost half the loans go to borrowers between the ages of 18 and 29. The overall repayment rate is 62 percent, but this could increase as more loans come out of the grace period. The BTS also lends to microcredit associations for onlending to microentrepreneurs.

### **West Bank and Gaza**

Although the West Bank and Gaza is the smallest country in the Middle East and North

Since 1998 the BTS has granted more than 22,000 loans worth a total of 100 million dinars

The microfinance programs in the West Bank and Gaza have the deepest outreach in the region

Africa, it is among the region’s leaders in terms of the number of programs making small loans. With 16 programs, it has just one fewer program than Egypt, the largest country in the region. But as in Lebanon, the balance is skewed—only three of these programs are engaged in traditional microfinance. The other 13 programs offer unemployment loans, very small business loans, or small and medium-size enterprise loans. Another unusual feature of the market is that five of the programs engaged in very small business lending and small and medium-size enterprise lending are run by private commercial banks, all following best practices.

*Microfinance*

The largest of the three microfinance programs, Palestine for Credit and Development (FATEN), controls about 70 percent of the market. All three programs follow best practices and target only women, mainly with group loans. At the end of 1999 the combined outstanding loan portfolio was \$2.1 million. The microfinance programs in the West Bank and Gaza have the deepest outreach in the region: their clients are among the country’s poorest citizens. The average loan balance is \$294, which is 18 percent of GDP per capita and 42 percent of the poverty line.

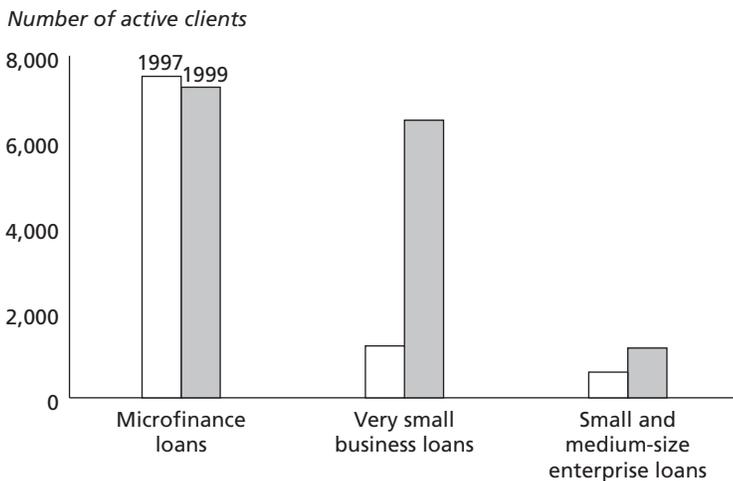
Given the high population density, especially in Gaza, it is not surprising that 77 percent of clients live in urban areas.

The West Bank and Gaza is the only country in the region that experienced a drop in microfinance clients between 1997 and 1999, from about 7,500 to 7,300 (figure 13). (The outstanding loan portfolio grew, however, indicating larger loans among repeat borrowers.) The main reason for the drop is that FATEN underwent crucial restructuring and consolidation. FATEN spun off from its parent organization (Save the Children), becoming an independent, locally owned and managed private company—an essential step toward financial and institutional sustainability. FATEN also had to deal with fraud issues that arose when rapid growth in clients was not backed by appropriate organizational changes. FATEN emerged from both experiences stronger and is now well positioned to capitalize on its experience and market position.

Another reason for the drop in clients is that the West Bank and Gaza may have a limited market for microloans that target the poorest. FATEN’s main competitor in Gaza, the group-guaranteed lending and savings program sponsored by the UN Relief and Works Agency (UNWRA), grew very little, and it was not undergoing structural changes. This could indicate market saturation.

FATEN hopes to diversify its loan portfolio, offering individual as well as consumer loans. Doing so would enable it to achieve the volume and scale needed for full operational and financial sustainability. The UNRWA, through its Micro Enterprise Credit program and Small Scale Enterprise program, started to diversify a couple years ago. The main constraint to the UNRWA’s full sustainability is its institutional setup, being lodged in a larger bureaucracy. Despite the competition and possible market saturation, the three microfinance programs in the West Bank and Gaza expect to reach about 25,000 active clients by 2004. This number includes new target groups such as very small businesses and consumers.

**Figure 13. Microfinance and other lending in the West Bank and Gaza, 1997 and 1999**



Source: World Bank surveys of microfinance institutions.

### *Very small business and unemployment lending*

The three very small business lending programs in the West Bank and Gaza are the UNRWA Micro Enterprise Credit program in the West Bank, the USAID-funded microcredit program with the Bank of Jordan, and the Arab Bank in the West Bank. All three programs offer working capital loans and have adapted lessons from microfinance to very small business finance (see also below, in the section on finance for small and medium-size enterprises). The initial loan size is substantially larger than in traditional microfinance programs. And with timely repayment, loans can reach \$5,000–10,000.

At the end of 1999 these three programs had about 6,500 clients, up from 1,200 at the end of 1997. The UNRWA Micro Enterprise Credit program was the main contributor to this growth. In 1999 the outstanding portfolio of the very small business programs was \$6.3 million. Only 5 percent of clients were female, and less than 10 percent lived in rural areas. The average outstanding loan balance was about \$1,000 in 1999. The three programs are on the road to operational and financial cost coverage and together expect to serve more than 15,000 active clients by 2004.

The five programs offering investment capital loans target unemployed or other marginalized groups. Hence the label unemployment lending programs is appropriate. As in other countries where this type of program has unemployment reduction as its mandate rather than the sustainable provision of financial services to the entrepreneurial poor, interest rates are subsidized—and in some cases are almost lower than the inflation rate.

At the end of 1999 these five programs had about 1,500 active clients, almost twice the number at the end of 1997. The average outstanding loan balance was about \$2,800. Almost half of the clients were female, mainly because three of the programs target only women. Almost half the clients lived in rural areas, mainly because two of the programs are engaged in agricultural or rural

lending. The programs claim that together they will reach more than 13,000 active clients by 2004.

### *Small and medium-size enterprise finance*

Five programs in the West Bank and Gaza target small and medium-size enterprises (those with fewer than 50 employees). At the end of 1999 the programs had almost 1,200 clients and an outstanding loan portfolio of \$9.1 million, with an average outstanding balance of \$7,800. More than a quarter of clients were female.

Three of the five programs are implemented through commercial banks under a project sponsored by the World Bank, International Finance Corporation, and Dutch government. The three banks—the Arab Bank, Commercial Bank of Palestine, and Jordan National Bank—offer investment capital loans of up to \$30,000 to small businesses. The maturity is up to three years. Interest rates and fees are high enough to cover costs. The unique feature of these programs is that they apply lessons from microfinance to small business finance.

The businesses financed are dynamic and sustainable, and many operate in markets with growth potential. Examples include:

- A woman-owned business producing large garments. Cheap imports from Asia produce only smaller sizes; thus this entrepreneur has found a market niche with ready and growing demand.
- An entrepreneur making neon signs—the first and only source of such signs in the West Bank.
- An entrepreneur making locally produced, processed, and packaged sauces, jellies, and herbs.
- A physician setting up a medical testing lab for a variety of tests that before could only be taken in Israel.

Financing businesses run by experienced entrepreneurs creates more sustainable jobs than helping unemployed people set up businesses (which are likely to fail). By March 2000 this project had helped create 1,100

Lessons from microfinance have been used in other lending programs in the West Bank and Gaza

Yemen  
experienced  
the region's  
fastest growth  
in microfinance

jobs—about 2 per business financed, excluding the owner. This is in line with international experience. But given the dynamism of the businesses financed, many can be expected to become repeat borrowers and create more jobs. Even more important is that two of the three banks are already making profits from this lending, giving them a major incentive to continue the program after the World Bank and International Finance Corporation withdraw. In fact, the three banks expect to finance 3,000 small businesses by 2004.

One of the two other small enterprise programs, the UNRWA Small Scale Enterprise program, also implements lessons from microfinance.

### Yemen

It is no surprise that Yemen, which only introduced microfinance in 1997, experienced the region's fastest growth—from 250 active clients in 1997 to more than 2,600 in 1999. The outstanding loan portfolio is about \$500,000 and the average loan balance is \$181. After Morocco, this is the second lowest average balance in the region. But if in Morocco the low average balance is the result of a dramatic increase in the number of new clients, in Yemen it reflects the fact that it is the poorest country in the region, with a GDP per capita of about \$263 and a poverty line of \$46.

Yemen's share of female borrowers increased from 1 percent in 1997 to 26 percent in 1999. Its share of rural borrowers also increased, from 10 to 27 percent. The largest program has about 2,000 active clients and aims to reach 7,500 by 2004.

Yemen's four microfinance programs have two unique features. First, all are implemented by the Social Fund for Development. Second, three of the programs—including the largest—use Islamic finance techniques.

#### *The Social Fund for Development*

The Social Fund for Development was established in 1997 as part of efforts to mitigate the effects of government reforms on vul-

nerable groups, especially the poor. The fund seeks to reduce poverty by improving living conditions and providing income-generating opportunities. A demand-driven mechanism is used to deliver two main activities: community development services such as health clinics, basic education (including classrooms for girls), and small public works; and income generation programs and microfinance.

Many microfinance experts have argued that social funds should not engage in microfinance, mainly because the provision of social (often grant-based) services does not mix well with the provision of financial services. And while social funds are technically autonomous, they are often under political pressure and cannot afford to be seen as charging "excessive and exploitive" interest rates.

Yemen's social fund was aware of these drawbacks but decided to provide microfinance while addressing some of the flaws of doing so seen in other social funds. The provision of microfinance was a strategic choice because the social fund considers poor people's access to financial services to be an important component of the country's social safety net. Access to financial services increases poor people's coping options and so reduces their vulnerability to external shocks. The Social Fund for Development established a separate team, the Small and Micro Enterprise Development unit, with separate accounting, recruitment, and other managerial elements (box 4).

The team's achievements are remarkable because all local implementation capacity—that of the team and that of the intermediaries implementing the programs—had to be built from scratch. This proved to be a unique opportunity. Yemen was not tainted by "worst practice" experience, so the team could build best practices right from the start. Political pressure emerged, and there were even questions raised in parliament. But the Social Fund for Development has withstood this pressure, mainly due to its achievements in the field.

#### Box 4. Microfinance and Yemen's Social Fund for Development

Yemen's Social Fund for Development has a Small and Micro Enterprise Development unit that aims to increase poor people's access to financial services by developing financially and institutionally sustainable microfinance institutions. It also aims to increase poor people's incomes by developing income-generating projects. In both cases the social fund supports eligible intermediaries or creates new locally owned and managed intermediaries (such as NGOs or cooperatives) that deliver these services to the poor.

Assistance to the intermediaries includes technical and financial assistance. Financial assistance covers operational costs until an intermediary can cover these costs from interest and fee income. The fund also provides loan funds, which are lent to the intermediaries (not given as grants) to instill financial discipline from the start. Technical and financial assistance is contingent on the intermediaries meeting time-based performance benchmarks. The loans made by microfinance institutions and the loans made by income-generating projects are priced according to best practice formulas and include the cost of funds.

The Social Fund for Development develops a microfinance institution when an area's potential demand is high enough to justify the investment in technical and financial support required to build a sustainable program. In areas where there is clear demand but where high volumes of active clients can never be reached, income-generating projects are set up.

During the first phase of the social fund (1997–2000), four microfinance intermediaries and six income-generating projects were set up. Because Yemen had no microfinance

experience, the fund was able to follow best practice standards from the start. The main lessons from the first phase were:

- There is large demand for microcredit for economic activity, and borrowers are willing and able to repay.
- There is also large demand for microsavings services, especially among very poor women.
- The poor also need other financial services, such as credit for consumption and insurance for events such as funerals and weddings, as well as life insurance.
- Microfinance intermediaries with the potential to become sustainable require intensive support because capacity has to be built from scratch; a long time horizon is needed.
- It has proven difficult to find eligible and trustworthy intermediaries.
- The likelihood of building a sustainable microfinance intermediary is highest in urban areas, where the potential for reaching scale is highest.
- Many regions (especially remote and isolated rural areas) harbor demand for microfinance, but the demand is too limited to justify the high investment required to develop a microfinance intermediary.
- Islamic finance principles can be applied to microfinance and income-generating services. But, especially with microcredit, Islamic finance principles may not be sustainable because the transactions costs may be too high.

#### *Islamic microfinance*

As noted, Islamic finance techniques can be applied to microfinance—but there are drawbacks, especially higher transactions costs for borrowers and lenders (see box 2). A few years ago, when Yemen's microfinance programs were being designed, most prospective borrowers rejected interest rates, saying they were haram—in discord with the Islamic code. (There was, however, a notable difference between prospective clients in north

and south Yemen: people in the south had fewer problems with interest rates.)

Clients' initial preference was for mudaraba (profit sharing) because it was closer to the principles of Islam. This preference also reflected clients' familiarity with similar mechanisms used by suppliers and other sources of informal finance. But clients recognized the potential conflict between the borrower and the microfinance program in determining the profit. A few did not like profit sharing

Most of Yemen's  
programs use  
Islamic finance  
techniques

because they were reluctant to reveal their profits. Many prospective borrowers initially expressed doubts about murabaha (buy-resell) because it appeared too similar to the forbidden practice of fixed interest rates. They liked the simplicity of the model, however.

Prospective borrowers and local religious leaders understood that a microfinance program would incur costs and that these costs had to be recovered if the program were to grow. They had no problems paying for these costs.

Yemen's microfinance programs started by offering both loan products. As was foreseen, applying the profit-sharing model was administratively burdensome. Moreover, borrowers did not always understand the repayment schedule (which had unequal installments), and loan officers had to juggle dozens of borrowers, each with different schedules. Surprisingly, determining profits was less difficult. The dynamics of the microbusinesses receiving financing were relatively straightforward, and as the programs gained experience they also learned how to judge business cash flows. For instance, everybody in a community knows the price of a baby sheep or goat that is bought for fattening in order to be sold just before the Eid holidays. Everybody knows the cost of fodder for fattening and

the sales price of the fattened animal because markets are very active around Ramadan.

Over time, more borrowers asked for the murabaha product because its equal repayments enabled them to manage their household and business cash flows more easily. The programs ended up buying goods for the borrowers of both loan products because in many parts of Yemen even the handling of money is considered haram. This approach created high transactions costs for the borrowers and the programs. Loan officers had to visit shops or markets with borrowers, who knew best what to buy. The logistics of doing this for a few hundred borrowers are cumbersome—doing it for a few thousand clients is mind-boggling. The programs had to include these costs in the price of the loan, whether a higher profit-sharing percentage or a higher markup.

Unforeseen problems arose with accounting for profits. A traditional microfinance program takes and accounts for profits each time a repayment comes in. Given the Islamic philosophy, Yemen's programs could account for profits only after the last installment of a loan was paid. In effect, this put the profit in the last installment, which is highly risky. Fortunately, Yemeni accountants found creative solutions to this problem.

## Enhancing Institutional Capacity: What Progress Has Been Made?

**A** good microfinance program committed to providing quality financial services to a growing number of poor people on an ongoing basis should be able to:

- Reach a large number of clients.
- Provide financial products and services at competitive prices. This implies high operational efficiency and the lowest possible transactions costs to clients.
- Mobilize the financial and technical resources required to achieve its goals.

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

The 1997 World Bank survey of microfinance institutions in the Middle East and North Africa highlighted the lack of institutional capacity in most of the region's programs—a shortcoming that endangered their sustainability and growth. Many programs were not implementing best practices and did not have the administrative and governance

structures needed to provide viable financial services to large numbers of clients. Several constraints were identified as major obstacles to the industry's development:

- The absence of clear missions and goals.
- The limited capacity of managers and staff (in terms of number and skills).
- The lack of internal procedures for measuring performance.

In September 1998 the World Bank Institute organized a four-day workshop in Marrakech, Morocco, for microfinance practitioners from the region (box 5). This first-ever gathering of regional practitioners discussed the findings of the 1997 survey. In addition, information on microfinance best practices (such as CGAP focus notes) was made available in Arabic. The workshop generated country action plans for achieving sustainable development of microfinance, to be replicated by individual institutions. In addition, there was agreement that training and technical assistance, adapted to the region's needs, were needed to build the capacity of microfinance institutions and help them implement best practices.

The 1999 survey found that more of the region's programs are implementing best practices—as indicated by the capacity to cover operating costs and to reach more clients. Among other things, this notable improvement is due to better and wider dissemination of and exposure to best practices, the emergence of new programs (such as banks and private companies) operating according to sound business principles, and the transformation of some programs into independent institutions dedicated to microfinance.

Learning needs  
change but  
never stop

Training  
needs vary  
widely

### **Box 5. The Marrakech microfinance workshop: cooperating with the competition**

The September 1998 World Bank Institute workshop on microfinance originally sought to help individual institutions develop strategies for building capacity in order to achieve sustainability. But many participants were hesitant to share information on their programs, so the objective of the workshop was changed to developing strategies to strengthen the industry at the country level.

Encouraging cooperation among microfinance competitors is precarious, and the individualism described above is not surprising. (For a few participants, the workshop was the first time they had sat in the same room as their competitors from across the street in their home countries.) But such individualism can undermine the development of a country's microfinance industry. Sharing basic information on issues such as bad borrowers can only help the industry, and could foster credit rating mech-

anisms that follow borrowers' track records over time. Moreover, networking at the country level can inform the policy dialogue.

The unwillingness to cooperate was most pronounced in Lebanon, Morocco, and the West Bank and Gaza. In other countries formal or informal networks of microfinance programs actively cooperate. The best-known example is the Egyptian Association of Micro and Small Enterprise Development programs, which associates microfinance programs at the working level. While some Egyptian programs harbor fierce competitors among managing directors, their staff members cooperate and share information. Similarly, Jordan's Access to Microfinance and Improved Implementation of Policy Reform (AMIR) program brings together several microfinance institutions and promotes best practices among them.

### **Improving skills**

Providing easy access to training and technical assistance is an important part of efforts to help microfinance institutions build their institutional capacity. The 1997 survey highlighted the lack of suitable training in microfinance best practices in the region and the need for more tailored technical assistance. By 1999 some donor-supported initiatives had emerged (see below) and more managers had been exposed to best practices through overseas training. But there is still a pressing need for more training and technical assistance adapted to local needs.

The 1999 survey found that training needs vary widely. This is not surprising given that new microfinance programs need basic training while older programs are facing second or third generation issues associated with larger, more complex organizations. Older programs need far more tailored training and specialized technical assistance. Respondents were asked to rank, from a low of 1 to a high

of 3, the importance of each identified training need; the results are shown in figure 14.

### **Training needs associated with spinning off**

Many of the region's microfinance programs are part of larger institutions such as international NGOs or governmental or quasi-governmental organizations (such as social funds or state-owned development banks). Such structures can limit growth, and after reaching a certain level of development a microfinance institution should consider spinning off or transforming into a separate legal entity. Among the reasons:

- The need for internal rules or procedures that might conflict with the parent organization's other activities or objectives. (For example, microfinance institutions require extensive internal controls to prevent delinquency and fraud.)
- The need for a clear identity, separate from the parent organization, to avoid sending clients mixed signals (as can happen when

a microfinance program is part of a social fund).

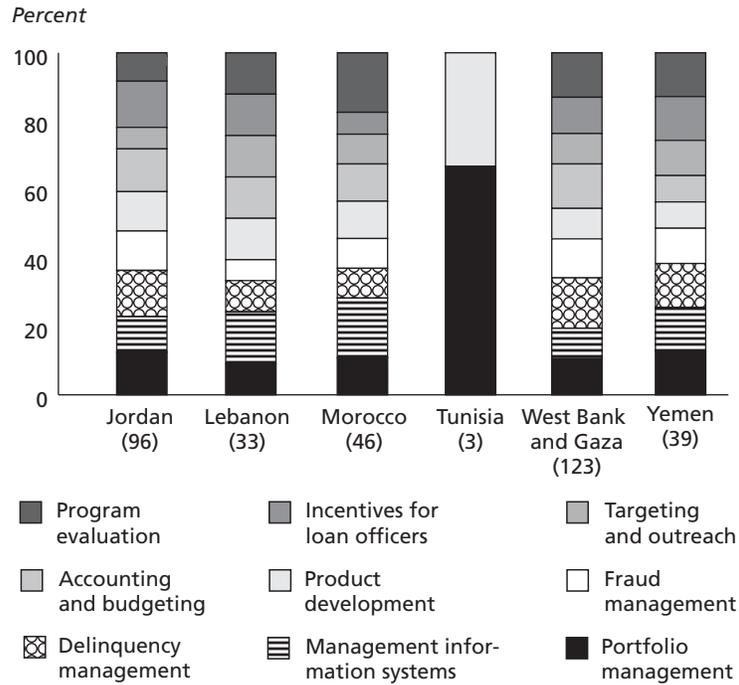
- The need to access commercial financial resources.

It is not easy to spin off and transform from a program into a locally owned and managed institution. The three successful spin-offs in the region—Al Majmoua in Lebanon, the Jordanian Microfund for Women, and FATEN in the West Bank and Gaza; see box 3—faced difficulties and experienced slow growth while the transition was under way. Cutting the cord from a parent organization that provided funds and assistance can be difficult. A short, well-planned transition is crucial.

Those transitions succeeded partly because of the involvement of program staff and newly established boards of directors. Their empowerment and sense of ownership made them fight to achieve their goals. This owner-like response can be fostered by giving staff shares in the new institution. Other important factors for success include appropriate timing, proper regulation, and strong involvement of all partners.

Although many of the region’s microfinance programs are lodged within larger, more socially oriented organizations—making a spin-off inevitable if their goal is financial sustainability—survey respondents did not identify the training needs associated with an institutional transformation. This could be because they do not envisage a spin-off or, more likely, because many program managers do not fully appreciate the many “invisible” services that their parent organization provides. These services include basic payroll management and human resource recruitment and management as well as specialized services such as fund raising, donor relations and reporting, and legal council. As the Save the Children spin-offs show, managing a program is not the same as managing an institution. Substantial training needs may arise and should be planned for if a program hopes to spin off.

**Figure 14. Distribution of microfinance training needs by country, 1999**



Note: Numbers in parentheses are number of respondents in each country. Source: World Bank survey of microfinance institutions.

**International, regional, and local training initiatives**

Since the 1997 survey several initiatives have been introduced to bolster microfinance training in the region.

*International initiatives*

Since 1997 donors have sponsored the participation of microfinance practitioners and government officials in well-known training programs such as the Boulder Institute’s in Colorado, Southern New Hampshire University’s Microenterprise Development Institute (MDI), and previously the Harvard Institute for International Development’s (HIID’s) in Massachusetts. To date more than a hundred individuals from the Middle East and North Africa have attended the Boulder course, and in the summer of 2000, 35 of the program’s 120 participants were from the region. Thus donors are willing to help microfinance institutions access best practices. Because the costs of doing so are signifi-

Several sources provide useful training in microfinance

cant—averaging \$10,000 per participant for the Boulder program—the relevance to the region’s needs must always be verified, especially since the language barrier remains an important obstacle. Given the importance of empowering local staff and developing remote programs, it is worth investigating whether such funds should be used to replicate and offer such programs in the region.

Most of the participants in the Boulder and MDI programs, which are given in English, have come from Egypt, Jordan, and Lebanon. Many microfinance program staff in the West Bank and Gaza and Yemen do not speak English and so face a language barrier. The language barrier is also high for staff from Morocco and Tunisia.

#### *Regional initiatives*

Several regional initiatives have emerged. Some have been tested and implemented, others are still at the embryonic stage. The most promising is the Sustainable Microfinance Training Program delivered by Jordan’s Access to Microfinance and Improved Implementation of Policy Reform (AMIR) program in collaboration with the Jordanian Institute of Banking Studies.

The program, a four-year project funded by USAID, is the first initiative that provides training in Arabic focusing on best practices and on establishing financially self-sustainable microfinance institutions. It consists of two courses. The basic course covers market analysis, product design and lending methodologies, accounting basics, loan portfolio monitoring, and the like. The advanced course, for managers of microfinance institutions, covers sustainability, credit and risk management, growth management, savings, tools for building a strong organization, human resource management, business planning, management information systems, and the like.

Each course involves 70–75 hours of training and hosts 20–25 participants. In 1999 the program trained 52 practitioners in the basic course and 16 Jordanian specialists in the advanced course. In the first half of 2000,

47 participants completed the basic course. The courses are usually spread over two months and take place after business hours. In the summer of 2000 the basic course was provided full time over a two-week period to make it more convenient for participants from neighboring countries. Course fees range from \$400–500. The initiative aims to achieve 75 percent sustainability by the end of 2000 and full sustainability by the end of 2001.

#### *The CGAP Microfinance Capacity Building Initiative*

Since 1997 the Consultative Group to Assist the Poorest (CGAP) has been forging partnerships with training institutes around the world to provide financial management courses to microfinance institutions. Having identified the insufficient skills of microfinance managers and staff as the main constraint to the industry’s development, the CGAP initiative seeks to enhance performance through training.

The courses have proven highly replicable within a framework provided by CGAP. After identifying partner institutes, CGAP provides course content, technical assistance to adapt that content, and quality control to ensure success. To date CGAP has implemented courses in East Asia (China and the Philippines), South Asia (India), and Africa (Kenya and Senegal). CGAP is exploring the possibility of implementing similar partnerships in the Middle East and North Africa. For more information, see “MFI Services” at <http://www.cgap.org>.

#### *Local initiatives*

Many institutions in the Middle East and North Africa are developing training directed at loan officers and mid-level staff. Many are based in Egypt, where institutions like the Alexandria Business Association and the consulting firm Environmental Quality International are providing training in Arabic for loan officers and supervisors. This training is open to participants from other countries. For this type of audience, the regional gap

between demand and supply has been tremendously reduced by such training.

To serve a higher-level (managerial and administrative) audience, networks like Egypt's Association of Micro and Small Enterprise Development are trying to use national institutions to build on existing training centers and in-house training providers, using their facilities and skills to develop programs and, with donor support, to get international experts to deliver courses. To date, however, no major initiative has emerged.

### *Getting and keeping the right people on board*

The 1999 survey found that most of the region's best practice programs have man-

agers with a private sector or banking background. Such a background generally enhances a program's business orientation and quest for sustainability. But getting such managers is hard, and keeping them is often harder. Most microfinance institutions' financial means are limited—especially when they stop receiving donor funding—and managers may be drawn to the higher wages offered by the private sector. The same is true for many of the valuable staff members a microfinance program spends time and effort training.

Thus microfinance institutions face two major human resource challenges: attracting suitable candidates and investing to improve their skills, and retaining them.



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