



ESAF BRIEF: Innovation, Best Practices & Knowledge Generation

A Palestinian MFI Takes a Commercial Loan

Background and Context

For many microfinance institutions (MFIs), the first step toward commercialization consists of taking out a loan. Ironically, though MFIs are in the business of disbursing and collecting loans, for the non-profit MFI manager, taking out a loan can be fraught with challenges:

- Most commercial banks are unfamiliar with microfinance and find it difficult to adequately assess the risk of lending to MFIs, creating a barrier to lending.
- MFIs must, therefore, not only have financial statements that show a profit and adequate equity, but also move their financial statements and reports into formats that commercial bankers expect. This may require additional reporting and controls.
- The culture shift of moving from a purely donor- or grant-driven operation to one with a commercial cost of funds can be a significant hurdle for MFI boards and management.

In spite of these road blocks, taking this first step towards more commercially-driven operations can be worth it for many MFIs. Few MFIs are able to achieve Tier I status (see **Figure 1**) on the basis of donor funding alone. These MFIs need other

sources of finance to maintain or expand their market share. While it's unlikely a commercial loan on its own will enable a MFI to leap to Tier I, it is a logical first step, and one that can force a level of financial discipline and transparency on a MFI.

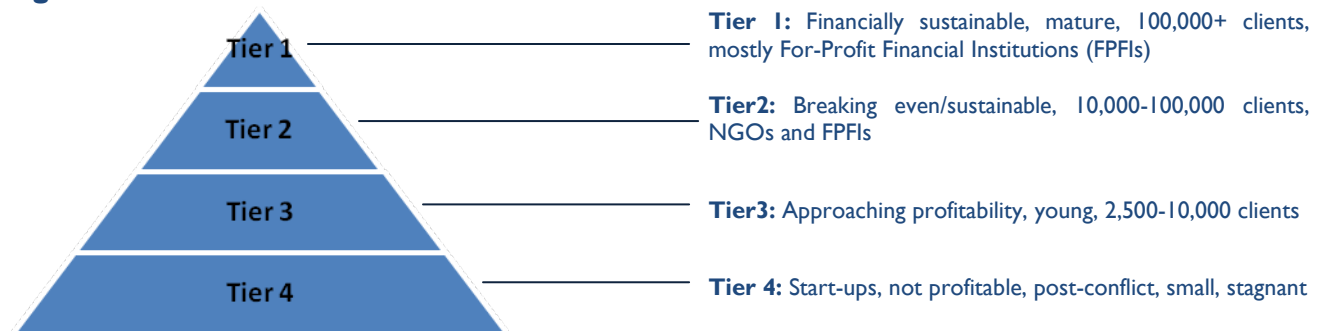
However, it can be easier for the more sustainable Tier I or Tier 2 MFI to access commercial finance (**Figure 1**). As so many borrowers have bemoaned, when you need a loan, you can't get one. When you don't need a loan, everyone wants to lend to you.

FATEN began operating as a financial service institution in the West Bank and Gaza in 1999. By year-end 2008, FATEN was one of the top three MFIs in Palestine. When the team of partners ShoreBank International (SBI) and the Expanded and Sustained Access to Financial Services (ESAF) program began working with FATEN in 2008, the MFI was projected to end the calendar year with a US\$12 million portfolio and nearly 5,000 clients. However, it was not consistently operationally or financially sustainable, relegating it to the Tier 3 class (**Figure 1**). The MFI would need to improve its efficiencies.



The Expanded and Sustained Access to Financial Services (ESAF) program is a three-year US\$36 million program, funded by USAID, and designed to build a more inclusive financial sector in the West Bank and Gaza, for Palestinian households and enterprises. ESAF is implemented by AED in partnership with The William Davidson Institute, ShoreBank International, CHF International, CARE and Save the Children, and is an Associate Award under the FIELD-Support Leader with Associates, which is managed by AED. www.microlinks.org/field.

Figure 1¹



¹ Foote, Sean. 2009. "SVMN Microfinance 101 Class One." PowerPoint presentation.

Type of Financing Available	Tier 4	Tier 3	Tier 2	Tier 1		
	NGO	NGO	NGO	FPFI	NGO	FPFI
Public						
Grants	X	X	X	X	X	X
Subsidized loans	X	X	X	X	X	X
Guarantees		X	X	X	X	X
Private debt						
Commercial loans			X	X	X	X
Guarantee funds			X	X	X	X
Bonds				X		X
Securitization				X		X
Commercial linkages			X	X	X	X
Private equity				X		X

According to FATEN management, the MFI had enough funds (both on-hand and through a “soft” loan from the United Nations Development Programme [UNDP]) to achieve a US\$16 million portfolio by end of fiscal year 2009. However, after 2009, the funding picture grew murky. In a gap analysis facilitated by ESAF and SBI consultants in December 2008, FATEN’s managers expressed targets of reaching a US\$20M portfolio by year-end 2010. The question of whether FATEN could make the leap to Tier 2 status, improve its profitability, and access commercial finance loomed.

Methodology

The SBI/ESAF team considered FATEN one of Palestine’s most promising MFIs for commercialization and began high-level conversations with FATEN’s board and managers regarding accessing commercial finance. As a non-profit institution, seeking equity investors was not an option for FATEN. That left either hoping for additional donor funding or commercial debt, such as a bank loan.

A culture shift. The FATEN board, worried that becoming more commercial might cause a drift in its mission, a valid concern. Pressures to grow and increase profits can move MFIs away from serving more economically disadvantaged or geographically remote markets because serving these markets may be less cost-effective. Market-driven growth can also cause cultural shifts within MFIs. To give the board a better understanding of how accessing commercial finance might help or hurt FATEN, in 2009, the SBI/ESAF team arranged for a study visit to the National Microfinance Bank of Jordan (NMFJ). Commercial finance was a cornerstone of NMFJ’s strategy, which was based on commercial borrowing rather than donor funding, and long discussions about commercial finance ensued between FATEN board members and NMFJ managers at this crucial field visit. FATEN’s board came away from the meeting convinced that commercial funding was a viable strategy that would enhance its mission.

Making sense of financials. The need for additional funding was clear, and FATEN’s

management was willing to try to obtain a commercial loan. But, FATEN's lack of financial sustainability was troubling, and the SBI/ESAF team's first step was to analyze what the issues were. FATEN had been orienting its financial statements toward perceived donor needs and, as a result, had inordinately aggressive loan loss reserves, which resulted in understated profits. By the end of 2009, FATEN adjusted the financials to reflect the true loan risk, showing a more realistic loan loss provision. FATEN's 2010 financials showed positive operating and financial sustainability.

Preparing a business plan. In addition to being useful planning tools, bankers also like to see business plans. Near the end of 2009, SBI consultants facilitated a business planning exercise. The resultant three-year plan's financial projections incorporated raising US\$7 million in funds from a variety of sources, including debt and microfinance investment vehicles (FATEN's CFO developed the projections for the plan using Microfin).

Knocking on doors. The final, and perhaps most frustrating, step was going to the banks to seek debt capital. According to FATEN's CFO, the banks asked for more documentation and had more stringent requirements than the donors. This was particularly bothersome since FATEN had secured a loan guarantee for the proposed loan from CHF.

FATEN ultimately narrowed prospects down to the two banks likely to give the loan: Bank of Jordan and Bank of Palestine. "We approached Bank of Jordan

first because they had an ongoing agreement with [the United States Agency for International Development (USAID)/Washington] Loan Guarantee Association," said Fares Abdelnour, FATEN's Finance and Administration Manager. The MFI used their new business plan as part of their loan application to the Bank of Jordan. However, negotiations fell through when the term sheet presented by the bank for a US\$2 million loan came with unacceptable conditions.

Bank of Palestine proved to be a bit more open to the concept of lending to a MFI, largely because the bank had experience as a microlender in the past and was contemplating restarting its microcredit program. Even so, hurdles remained. With the high levels of collateral in the bank's normal lending practices, bank managers claimed they never had to write off their commercial loans and were unsettled by FATEN's write-offs (which were at quite normal levels in the microfinance industry). SBI engaged in one-on-one sessions with bank managers on microfinance industry standards, attempting to answer their questions about industry practices and set their minds at ease. In the end, Bank of Palestine obtained enough information about FATEN and the industry to offer FATEN a US\$1 million commercial loan.

Securing a loan. In March 2010, the SBI/ESAF team met with FATEN's board to approve the business plan and discuss the Bank of Palestine offer. SBI/ESAF encouraged the board to give the loan serious consideration. Without the additional funds,

The Banker's Point of View

The SBI/ESAF team worked not only with FATEN, but also with its lender, the Bank of Palestine. Bank management expressed two main concerns regarding lending to a MFI: the lack of a business plan and the absence of tangible securities that could be taken as collateral. The team worked with FATEN to develop a comprehensive business plan, and FATEN was able to take advantage of a guarantee fund to allay concerns about collateral.

In the end, bank managers cited this guarantee as a key point in FATEN's favor, along with the volume and quality of the MFI's loan portfolio.

There was also an element of socially responsible investing. According to Hashim Naser, the bank's manager, "the Bank of Palestine has a social responsibility to help FATEN in continuing its role in community development and reducing poverty, given that we are the first national bank in Palestine."

the MFI's growth would soon come to a halt, and the SBI/ESAF team was concerned that an offer from a third bank was unlikely. Since the process of negotiating with each bank had taken several months, turning down the Bank of Palestine loan would result in an interruption of the MFI's growth. FATEN's board decided to give one board member the authority to negotiate. It then identified terms and conditions it would like revisited, but agreed that if the bank held firm, the board would accept the terms as presented.

The bank did hold to the major terms, but FATEN was able to gain some concessions and secured the loan. They anticipate that with a loan under their belt and paid back on time, the next one will be provided on better terms.

Elements of Evidence-Based Program Design

SBI began working with the FATEN team on commercialization in late 2008. It took over a year to prepare the MFI for a commercial loan and then to acquire the loan from a local bank. FATEN struggled with the typical challenges MFIs face when seeking a commercial loan: the demands of additional reporting, changes to their financial statements, the hurdle of lenders unfamiliar with the microfinance industry, and fears of mission drift. Once FATEN was ready to apply for a loan, the negotiation process to reach an acceptable offer took months, in spite of having an external guarantee fund to rely on.

The assistance the SBI/ESAF team provided went beyond business plans: Board education was a critical component, as was education for the commercial bank managers considering FATEN's loan. Finding a local bank with a willingness to take the time to learn about the microfinance industry was crucial.

Conclusion

In the end, FATEN found in the Bank of Palestine a commercial bank that was committed to inclusive finance and willing to try to make the situation work. "The Bank of Palestine showed readiness and willingness to work with MFIs," said Abdelnour. "The bank has a good [relationship] with FATEN, it offered a competitive rate, and was using the loan guarantee fund program that CHF offers."

When asked if securing the loan was worth the work and frustration, Abdelnour was positive. "Once we got the new liquidity," he said, "we transferred it into the revenue generating wheel, i.e., injected it into the outstanding portfolio. With the same level of operational expenses and staff, we managed to increase the number of loans disbursed through efficiency, to decrease PAR>30 days [to 1%] through improved portfolio quality, and to increase operational and financial sustainability through profitability."

FATEN has broken through a barrier and moved into Tier 2 MFI rankings as a fully sustainable MFI. It has also gained loan capital for growth and is now on track to achieve its goal of a US\$20 million portfolio by the end of 2010 (see [Table 1](#)), all without sacrificing its mission.

Table 1: FATEN Results to Date

	FY 2007	FY 2008	FY 2009	June 2010
Number of Active Clients	3,771	4,954	7,008	8,597
Outstanding Portfolio (Millions of US\$)	4.68	8.33	12.19	19.48
Operational Sustainability	92%	82%	125%	198%
Financial Sustainability	77%	72%	102%	149%