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Palestine Economic Policy Research Institute

The Impact of Implementing the Palestinian
Banking Law on the Performance of
the Private Sector

2008

The Palestine Economic Policy Research Institute (MAS)

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Mission

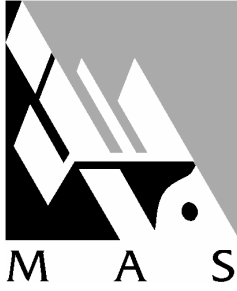
MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

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- ◆ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ◆ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ◆ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ◆ Disseminating up-to-date socio-economic information and research results.
- ◆ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- ◆ Strengthening economic and social policy research capabilities and resources in Palestine.

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This study was prepared by Palestine Economic Policy Research Institute (MAS) research team, particularly by the following researchers:

Research Team:

Dr. Fathi Srouji, Research Coordinator
Ibrahim Abu Hantash, Research Associate
Mohammad Khalifeh, Research Associate
Ibrahim Shikaki, Research Assistant

Reviewers:

Dr. Basim Makhool, Economist.
Nabeel Abu Diab, General Manager of the Bank Association of Palestine.

Editorial Assistant:

Abdel Ruhman Y. Abu Shamaleh (Arabic)
Jake Lomax (English)

Layout:

Lina Abdallah

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Foreword

The past decade witnessed remarkable growth in the Palestinian banking sector, with more banks offering more services from more branches, and the value of deposits doubling over the period. However, lending to the private sector did not increase at the same rate. Given the vital importance of a healthy and well-regulated banking sector to economic growth, it was a key task of the Palestinian Authority to introduce legislation to govern the operation of banks and enhance their performance. The Banking Law of 2002 was the first attempt at this, and MAS studied the draft of this law before it was enacted.

Over five years later, the Palestine Monetary Authority (PMA) is preparing to update the law, taking into consideration the financial, economic and technological developments in the Palestinian economy in recent years. Once again, MAS reviewed the law and examined how well it will serve its purpose. Fittingly, this forms part of a series of research aimed enhancing the competitiveness of the private sector, for which success in overcoming the many challenges it faces requires an enabling environment founded on well-drafted economic laws.

I would like thank all those who cooperated with us in this study, especially the PMA, who provided us with various remarks and valuable details about the draft law. Many thanks too go to the experts we interviewed, the participants at the workshop during which the study was presented and discussed, and the reviewers of the first draft of the study, all of whose input greatly benefited the study. I would also like to thank the research team for their efforts to produce such valuable paper. Lastly, I want to extend my thanks and appreciation to the International Development Research Centre (IDRC), Canada, for funding this series of studies.

Dr. Mohamed Nasr
Director General

Executive Summary

Background

The legal and regulatory environment is one of the most significant determinants of competitiveness within an economy. This is because of the importance of the legal framework in governing the relationships between producers, investors and consumers.

Since the PNA's creation in 1994, it has formulated a number of economic laws with the objective of regulating the relationship between the various economic actors and organizing the operations of the different economic sectors, including banking. Among the most important laws are the Monetary Authority Law and the Banking Law of 1999 (amended 2002). The Palestinian Monetary Authority (PMA) has recently drafted a replacement to the existing Banking Law. MAS carried out a critical study of the current Banking Law before it was ratified and enacted in 2002. Five years after the enactment of this law, this new critical review updates the analysis of the law to examine its impact on the competitiveness of the private sector. This review also includes a regulatory impact assessment of the new draft law.

Banking Systems

The banking system facilitates the transfer of funds from non-productive (or less-productive) players to productive areas of the economy. Economic activity is affected by the banking system in the short term and the long term. The activity of banks may have immediate impact upon the economy by enabling investors and beneficiaries to fund productive activities. Over the long term, productive activities that benefit from banking services produce further commodities and services to fill the increasing demand that results from increased lending. The banking sector and the economic situation are inter-related and mutually dependent; there is a great deal of literature on the banking sector in advanced economies that supports this view of codependence between the banking sector and economic activity. The worldwide recession in the early 1930s disrupted the performance of the banking sector, while the sector prospered in the economic growth that followed World War II. On another level, the banking crisis in the early 1980s affected the economies of many countries, and the extent of inter-relation was particularly exposed in recent world market crises, especially that in South East Asia in 1997.

Due to this close interrelation between the banking sector and other economic activities, banking legislation constitutes a concern for researchers, banking practitioners, and banking industry observers. There are many motives for banking regulation, and this creates variation in the nature of legislation issued. Notwithstanding this variation, three overriding goals of banking legislation can be identified: to create an appropriate competitive environment for the banking sector; to ensure the quality and security of banking operations; and to introduce preventive measures to avert banking crises and to mitigate the impacts of the same. This will naturally be reflected in the performance of the various economic sectors and the behavior of economic actors. The behavior and confidence of **depositors and shareholders** in banks vary in terms of standards of protection, deposit guarantees and sound management of banking vehicles, as well as respect of confidentiality of bank data, protection of shareholders' rights and the internal and external oversight prescribed in such legislation. **Borrowers and beneficiaries** of banking services are also impacted by the extent to which banking legislation ensures a competitive environment among banks. This includes norms related to governance, transparency, disclosure and rules to prevent monopolies. Sound banking legislation safeguards **monetary stability** in states, as it controls the mechanisms of cash supply in the economy. Regarding **banks themselves**, rigorous banking legislation will reinforce their performance and efficiency by specifying the basis of the relationship between the supervisory authority (normally the central bank) and banks. Legislation also regulates the activities of banks to ensure their sustainability and avoid any full or partial collapse of the banking sector.

Features of the Palestinian Banking Sector

The Palestinian banking sector is characterized by a number of features, including:

- a. The number of branches of banks working in OPT increased from 57 to 159 branches between the years 1995 and 2007. It is notable that the majority of banks are commercial, foreign banks. This fits poorly with the properties of the Palestinian economy, and hence minimizes the contribution of banks to enhancing performance of the productive sectors.
- b. Deposits doubled in the period between 1997 and 2006 to reach US\$ 4.2 billion. Deposits constituted 93.2% of Gross Domestic Product in 2006.

- c. Bank liabilities were US\$ 1.9 billion in 2006, representing 41% of the total bank deposits. This is a low percentage in comparison to other countries. The figure is 68% in Jordan, 80% in Egypt and 96.3% in UAE.
- d. Overdrafts represent about 37% of such liabilities, in comparison to 63% in loans. Statistics show a small share of credit goes to manufacturing sectors, accounting for only 18% of bank lending, while credit granted to the agricultural sector remained low at a mere 0.81%. The industrial sector received 6.2% of total credit, construction 11% and the public sector 25.4%.

Approach

The research team determined a number of criteria as a basis to carry out the regulatory impact assessment. Consultations were held with different stakeholders having relations with the Palestinian banking sector. Experiences from other countries in banking legislation were also reviewed. The theoretical framework of the interrelation between the banking system and economic activity on the one hand, and between legislation and the banking sector on the other constituted an important reference in assessing Palestinian banking legislation. Below are the most important criteria applied by the research team in analyzing the impact the enactment of the banking law on the performance of the private sector.

❖ **What form of banking law is needed?**

The nature of the banking system in any country is interlinked with its political and economic system. The functions and roles to be played by the banking sector depend largely on existing administrative and legal structures. In reviewing the banking law, the proposed amendments to the law, and the circulars and regulations issued by PMA, it is noted they are insufficiently tailored to the specificity of the Palestinian economy, which is still in the stages of formation and development. They did not grant any exceptions or preferential treatment to SME credit organizations, although SMEs account for the majority of Palestinian enterprises and the SME sector represents the engine of the economy in terms of both production and employment.

❖ **Factors limiting the stability of the banking system**

The unstable political situation has led to a total deterioration of economic conditions, which has increased the risks faced by banks and investors alike. The weakness of judicial authority contributes further to this risk. Moreover, the agencies enforcing judicial rulings are

inefficient, which undermines the security of the banking sector and marginalizes its role in impacting economic activities.

❖ **Relationships with regulatory authorities**

Palestinian banking law applies best practice and internationally accepted norms in the areas of bank governance, management and oversight, and in the regulation of the relationship between the PMA and banks. It is quite similar to other Arab banking regulations, which are enacted under situations not dissimilar to that of OPT. In its written form, they protect the security of the banking sector and establish a balanced relationship with its supervisory authorities, while striking a balance between two types of agency: citizens to regulators; and depositors to banks. The proposed amended legislation gives additional powers to the PMA. These include: entering into premises where it is suspected that unlicensed banking operations are being conducted; determining the grace period granted to banks to dispose of real estate instead of it being determined by law; calling shareholders of the bank for a general assembly meeting in the event that the bank's board of directors contravenes internal bylaws by not calling such a meeting itself; and conducting special inspections at any time when it has reasons to believe that there is an important reason to investigate the bank's financial wellbeing.

Enforcement of the provisions of the Banking Law that govern the nature of relations between the PMA and the banking sector components depends largely on contradictory opinions and interpretations. On the one hand, annual reports of the PMA refer to its supervisory role as an overseer of banks. It issues many memos and circulars to promote measures that safeguard the safety and sustainability of this sector and to promote efficiency and quality in banking services. On the other hand, some observers might suggest that the PMA has too free a rein in the way in which it interprets and enforces legislation, and that it does not follow strictly enough the letter of the law.

❖ **Factors to attract additional deposits**

Banks' ability to attract additional deposits depends on a number of factors. Most important among these are: public awareness of the advantages of depositing savings in banks rather than outside the banking system; the safety of the banking system and public confidence therein; preservation of confidentiality of data; deposit interest rates; as well as the general economic and political situation.

Article 15 of the current law sets forth the terms by which banks may accept deposits, whether it is with or without interest. The law left it to the PMA to motivate banks to attract deposits. Article 78 states that the PMA, in cooperation with banks operating in OPT, may establish an institution to warrant loans and deposits. Such an institution has yet to be created. Article 26 prescribes data protection procedures to preserve customer confidentiality.

❖ **Factors to expand credit facilities**

In order to achieve the goals of monetary policy, a key tool is the extent and type of credit that may be granted. Hence, reviewing the limitations on that credit remains the key aspect of any assessment of banking legislation, because it determines the effectiveness and limitations of monetary policy and its ability to impact on economic activity.

The ability of banks to determine the extent of their credit facilities depends on a number of factors related to supply and demand. It firstly depends on the banks' ability to attract deposits and savings (supply). Another determinant of the banks' capacity to extend credit facilities is the external constraint of the PMA's use of monetary policy. The PMA cannot set interest rates as the ability to use the interest rate as a tool depends on having a national currency, which PMA does not have. Article 35 of the Banking Law allowed the PMA to identify appropriate rules to govern the regulation of credit, including setting credit ceilings, credit costs and credit terms. Article 36 stipulates that PMA shall have the right to specify the liquidity reserve that banks must retain in relation to their activity. It shall specify the minimum liquid assets that must be retained, and determine how these will be calculated. Article 37 refers to the PMA's authority to specify the requirements of banks' obligatory reserves, and the dividends the PMA may consider paying to banks on such reserves. The proposed draft legislation did not change these powers.

Recommendations

Based on the findings of the study, a number of recommendations have been made to strengthen the role of banks and to better enforce the provisions of the legislation, so as to improve the performance of the banking sector in funding the development of the OPT.

- ❖ Because the Palestinian economy is in the early stages of development, and over-dependent on certain production sectors, the Palestinian

Banking Law should include provisions referring to the creation of specialized development banks for various economic sectors as well as regular banks.

- ✧ The current Banking Law does not include specific reference to SME credit institutions. But because of the importance of the SME sector to the Palestinian economy, the new draft legislation should have some focus on SME credit institutions. It should define what is meant by a SME credit institution in terms of their operational procedures and their *raison d'être*, and granting them preferential treatment.
- ✧ The proposed draft legislation grants significant additional powers to the PMA. These are not in line with contemporary banking developments, and such powers are not paralleled in other countries. In this regard, we propose to remove the following articles from the proposed draft legislation: Article 4.4, Article 17, Article 28.4 and Article 53.
- ✧ The study suggests amending Article 33.2 of the draft legislation, which refers to data protection. These measures should apply not only to current board members and responsible employees in banks and credit institutions, but also former employees and board members.
- ✧ It is necessary to ensure that the PMA uses its powers effectively in determining obligatory reserves, credit ceilings and liquidity rates. It must strike the necessary balance between ensuring the safety of the banking sector and strengthening its role in supporting and financing economic development.
- ✧ It is necessary that the proposed draft legislation includes articles that regulate e-banking, and the use of electronic data as evidence in banking legal disputes.