

2012

Islamic Microfinance Case Study  
Arab Center for Agricultural Development (ACAD)

A draft to be discussed in the Islamic  
Microfinance Conference, Saudi  
Arabia – April 2012



Sanabel: The Microfinance Network  
for Arab Countries  
Agence Française de Développement

## Preface

This study is one in a series of three case studies that aim to shed light on some pioneering Islamic microfinance models. The scope of each study includes a presentation of an Islamic MFI's outreach, product offering, and overall financial performance. Each study also highlights lessons learned and provides recommendations to MFIs that may be considering expanding their current products mix to include Islamic microfinance products.

The focus of this study is to outline the Arab Center for Agricultural Development's (ACAD) experience in terms of Islamic financing models, compliance with *sharia* (Islamic law), social responsibility, financial and social sustainability, and extent to which the services are in-line with the institution's overall vision, mission, and objectives. Moreover, the study provides an assessment of the key challenges and lessons learned in the design and implementation of Islamic microfinance products as well as lessons learned and recommendations to this regards.

The case study was prepared as a result of information exchange conducted with ACAD as well as an analysis of the 2011 Islamic Micro and Small Medium Enterprise (MSME) Finance Survey<sup>1</sup> (which was provided by ACAD's management), in addition to desk research and analysis.

**This *case study* was commissioned by AFD as an independent input into CGAP's MSME Islamic Microfinance Survey.**

---

<sup>1</sup> A Survey conducted by CGAP, in collaboration with Sanabel and Al Baraka Banking Group to survey is to assess the delivery and scale of Sharia compliant financial services to MSMEs.

## Table of Contents

I.	Overview of Microfinance in Palestine .....	4
I.	Islamic Microfinance Landscape in Palestine: .....	5
II.	Microfinance Legal Framework in Palestine .....	6
A.	Overview of the Arab Center for Agricultural Development (ACAD).....	7
III.	Institutional Characteristics.....	7
A.	Political environment.....	7
B.	Management and Organization Structure .....	8
C.	Gender approach .....	9
IV.	ACAD's Microfinance Products .....	9
V.	Islamic Microfinance Products .....	10
A.	Murabaha:.....	11
B.	Musharaka:.....	13
VI.	ACAD's Financial Performance .....	14
A.	Financing Sources .....	14
B.	Outreach.....	15
C.	Profitability.....	17
D.	Productivity and efficiency .....	18
E.	Portfolio quality .....	19
F.	Client impact.....	20
G.	Transparency .....	21
H.	Cost to clients .....	21
I.	Client feedback .....	21
VII.	Lessons Learned from ACAD Case Study and Recommendations for Successful Design and Implementation of Islamic Microfinance Models: .....	23
VIII.	References.....	25
IX.	Appendixes.....	26
A.	Abbreviations and Acronyms .....	26

## I. Overview of Microfinance in Palestine

2 Fast Facts Palestine - 2012	
HDI	110
life Expectancy	73.3
Adult Literacy Rate	93.8%
Real GDP Growth	0%
GDP per capita	1.261
Population	3.9 million (2.4 in West Bank and 1.5 in Gaza Strip)
Poverty Rate	34.5%
Unemployment Rate	22.8%
Population Growth Rate	3.7%

Over half of Palestinians live in Poverty: 45.7% in the West Bank and 79.4% in Gaza. With the suspension of aid to Palestine in 2006 the number of people in deep poverty, (defined as those living on less than 50 cents a day) nearly doubled to over 1 million.

Unemployment, under the ILO definition, has increased in the first quarter of 2008 from 22.6% – 25.8% in Palestine as a whole. In the West Bank unemployment actually lowered (19%-16.3%), while in the Gaza Strip it has heightened considerably under the Israeli siege (29.8%-45.5%). Labor force participation as a whole in Palestine is 40.6%<sup>3</sup>.

According to the United Nations Relief and works Agency (UNRWA) 46% of Palestinians do not have enough food to meet their needs. The number of people in deep poverty, defined as those living on less than 50 cents a day, nearly doubled in 2006 to over 1 million.

One out of four Palestinians in the West Bank and Gaza Strip was living below poverty line in 2010, said the Palestinian Central Bureau of Statistics (PCBS). This was divided into 18.3% in the West Bank and 38.0% in Gaza Strip.

With only 23% of the potential microfinance demand in Palestine covered by Microfinance Institutions (MFIs) and almost 50% of Palestinians in the West Bank and Gaza living below the poverty line, demand for microfinance services in Palestine remains high<sup>4</sup>. Moreover, as result of the Israeli government's restrictive policy on the transportation of men and goods, and the subsequent high unemployment rate, many Palestinians have turned to self-employment activities, consequently boosting demand for microfinance services in the country.

Microcredit demand in Palestine was estimated to be between 150,000 and 190,000 Palestinian households according to Planet Finance, 2011 Faten's rating report<sup>5</sup>. In addition, it is estimated that

<sup>2</sup> UNDP Database: West Bank & Gaza, <http://www.undp.ps/en/index.html>

<sup>3</sup> Poverty in Palestine: the human cost of the financial boycott, Oxfam International, April 2007

<sup>4</sup> [Planet Finance, Faten 2011 rating report march 2011](#)

<sup>5</sup> Faten Planet rating report, 2011, ([http://admin.faten.org/userfiles/file/PlanetRating\\_FATEN\\_2011\\_pdf.PDF](http://admin.faten.org/userfiles/file/PlanetRating_FATEN_2011_pdf.PDF))

96,000 households demand Small and Medium credit and a further 200,000 households demand small-balance savings accounts and money transfer services.

The microfinance sector is made of 13 MFIs with various legal structures and one microfinance bank (Al Rafah Bank). The 13 non-bank MFIs are active or associate members of the Palestinian Network for Small and Micro Finance (Sharakeh), and eight of which reporting regularly to the Microfinance Information eXchange (MIX) market.

According to the micro focus (outreach report) published by Sharakeh ([www.palmfi.ps](http://www.palmfi.ps)) for September 2011, the numbers of active clients of the network member <sup>6</sup>MFIs declined by 3% compared to December 2010 to reach 43,133 clients with an outstanding loan portfolio of USD 74.72M. The two largest MFIs in Palestine namely; FATEN and UNRWA, collectively serve 27,000 clients which represents more than 50% of the market of active borrowers. Both of the MFIs are well-funded, and often benefit from foreign technical assistance and are operationally the strongest within the Palestinian sector.

Despite the diversity of demand, most Palestinian MFIs offer only microloans as saving is not allowed under the current regulatory framework. It could be fairly stated that MFIs operating in Palestine face many operational, regulatory, economic, and political challenges, which raises their operating costs above regional benchmarks and affects their portfolio quality and impacts their sustainability and growth plans.

## II. Islamic Microfinance Landscape in Palestine:

Currently, seven MFIs, namely; Faten, PARC, Reef, Islamic Relief Palestine, ACAD, PFD, and Asala are providing Islamic microfinance services in Palestine, serving more than 3,300 clients with a total gross financing portfolio of USD 11,416,678, as reported to the 2011 Islamic Micro and Small Medium Enterprise (MSME) Finance Survey. Six out of the seven MFIs offer *Qard Hassan* (zero interest rate loans) to clients and also offer *Murabaha* (cost plus mark-up). ACAD operates in rural areas and offers two products other than *Qard Hassan*, *Murabaha*, and *Musharaka*. Moreover, ACAD has one of the lowest average financing amounts per client, indicating deeper outreach.

Table 1 - Islamic Microfinance Providers in Palestine in 2010: Outreach and Scale

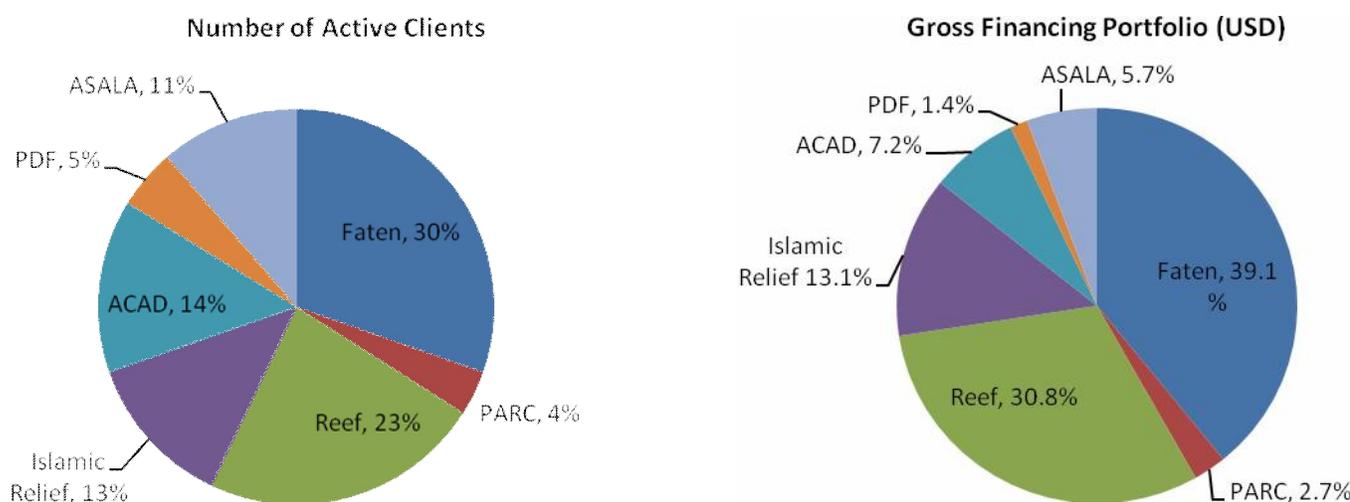
MFI name	Number of Active Clients	Gross Financing Portfolio (USD)	Financing Products
Faten	1,013	4,468,551	Murabaha
PARC	122	303,909	Murabaha Istisna Qard Hasan
Reef	769	3,511,529	Murabaha Musharaka

<sup>6</sup> Asala, UNRWA MD, Faten, CHF-Ryada, Women fund, PDF, REEF, YMCA, ACAD.

ACAD	471	822,075	Qard Hasan Murabaha Musharaka
PDF	163	161,842	Murabaha
ASALA	378	648,772	Murabaha
<i>Total</i>	<i>3,336</i>	<i>11,416,678</i>	

Source: Sanabel, and Al Baraka Banking Group, "Islamic Micro, Small, and Medium Enterprise (MSME) Finance Survey", 2011.

Figure 1 - Islamic Microfinance Providers in Palestine in 2010: Outreach and Scale



### III.

## IV. Microfinance Legal Framework in Palestine

The Microfinance sector is not regulated in Palestine, MFIs are registered with the Palestinian National Authority bodies under various legal statutes (i.e. UN agency, NGO, cooperative, etc.). A recent presidential decree delegated to the Palestine Monetary Authority (PMA) the authority the power to license, monitor and supervise MFIs.

The PMA as the sole supervisory authority of all MFIs in Palestine - whether NGOs or companies and according to the recent Banking Law (passed in November 2010) All existing NGOs are required to

become companies (either for-profit or non-profit). New financial institutions must receive a license from the PMA for their lending activities.

## V. Overview of the Arab Center for Agricultural Development (ACAD)

The Arab Centre for Agricultural Development (ACAD) is registered as a non-profit NGO in Jerusalem since 1993, and is also registered by the Palestinian Monetary Authority (PMA) since 2001 according to Palestinian Law. ACAD has been supported by different foreign organizations and has established partnership with institutions like the European commission EC (the major donor), the Islamic Development Bank, and the French NGO SIDI to strengthen its managerial capacity.

ACAD is specialized in microcredit to encourage small and micro enterprises in the agricultural and non-agricultural sectors.

*Mission:* ACAD is a development institution established to encourage micro entrepreneurship through small income generating activities among the poor and low-income individuals. ACAD provides financial and business support services concentrating on rural and/or high poverty rate Palestinian areas that are particularly affected by the difficult political situation. Economic independence and consequently food security for the poor and disadvantaged, is ACAD's main goal; to empower and promote active participation in the economic, social and political spheres of life in Palestine.

### *Objectives:*

- Promotion of self-sustaining employment and income generating projects in the agricultural sector and rural areas.
- Expanding geographical access to financial resources.
- Graduating poor and small rural producers into capital lending markets by shifting the balance power towards those needing credit.
- Mobilizing rural savings.
- Developing & empowering rural marginalized communities.

## A. Institutional Characteristics

### 1. Political environment

ACAD operates in a challenging external environment. Apart from the conflict prone nature of its operational area, people in general suffer from restrictions on the free movement of goods and services. These restrictions affect the clients' ability to repay their loans, the organization's ability to effectively control and monitor operations and to facilitate trainings. Over the years of conflict in Palestine, frequent rescheduling of loans by various MFIs has impacted the credit environment. The use of Israeli currency pre-empts the PMA from having its own monetary policy, which creates currency risk for the clients. The organization has done well to survive amidst the challenging political and economic environment in the country.

## 2. Management and Organization Structure

ACAD has its head office in Ramallah and has set up its seven urban and rural branches in all the major towns of the West Bank and Gaza strip. ACAD has a small team of 42 staff members (55% are on the field) which includes 8 managerial staff members at the HO. ACAD needs to review the staff allocation, more than 40% of staff is handling administrative activities which influence negatively the performance of the MFI.

ACAD's microfinance operations are led by the General Manager, Mr. Samir Bargouthi. Mr. Samir has been managing ACAD since 1992. He is supported by two senior managers, the Head Operations and the head of Finance & Administration. Among the senior management, ACAD also has a Compliance Officer who performs the role of the internal auditor in ACAD, as outlined in the organizational chart below.

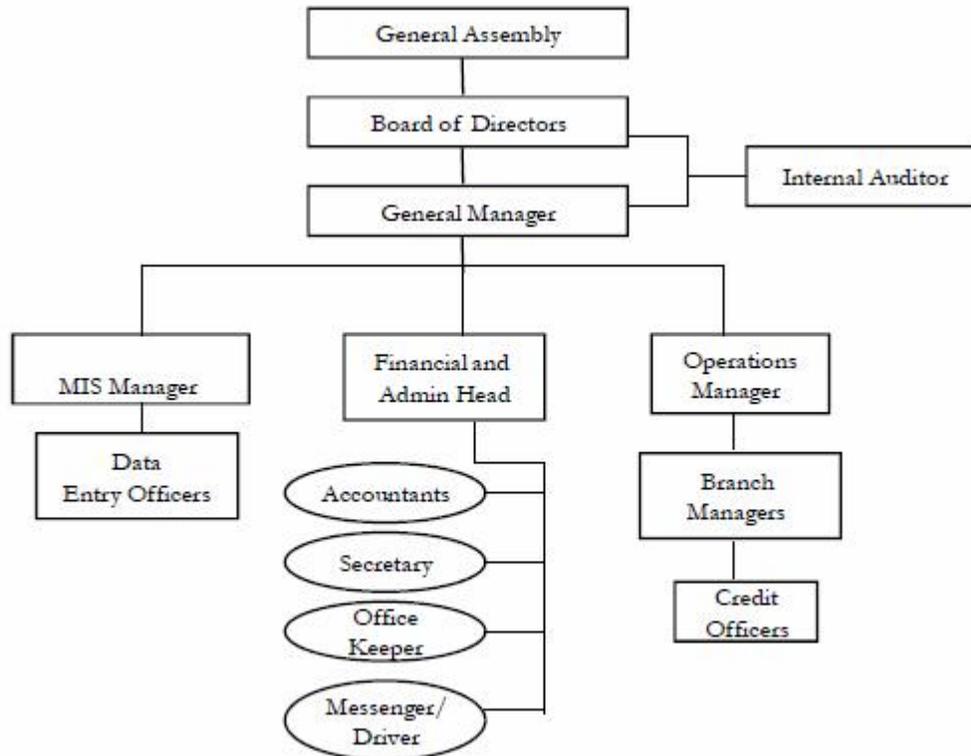
In reference to the rater's<sup>7</sup> point of view, ACAD has a reasonable performance on governance and strategy due to experienced Board members, the good experience of senior management in working in challenging local conditions, helps in loan products design and linkages with microfinance networks and financial institutions.

However, lack of experience of microfinance among the Board members, a centralized organizational structure, high dependence upon international donors and adverse economic and political outlook in the country has limited the grade.

Figure 2 - ACAD organizational chart 2010

---

<sup>7</sup> 2010 M-Crill rating report



### 3. Gender approach

Three of ACAD's nine Board members are women. Moreover, 86% of the field staff and 8 out of 10 office staff are women, many of whom have been recruited to market and handle loans to woman clients. Overall, women constitute 63.7% of all staff, and 10% of the top and middle management. With respect to clientele, women borrowers constitutes XX% of total borrowers by the end of 2011.

## VI. ACAD's Microfinance Products

ACAD offers four loan products to its clients that have an established business or a project idea in all type of sectors. Apart from *lending to farmers*, ACAD provides loans for *setting up micro-enterprises* as well as *Islamic loans*, and *consumer loans*. It also provides business support services including agricultural extension services, training, and community empowerment services. The organization also provides loans and technical assistance to 20 savings and credit cooperatives in Palestine.

ACAD also offers loan products in a mode that complies with Islamic principles. The target populations and means of utilization of the loans are the same. While women are eligible for all loans, the 'women loan' products is exclusively for women and covers both production and consumption needs, while all other loans are for productive purposes only.

The micro and small loans are offered to micro-entrepreneurs with existing projects for the expansion of their businesses. Loans are also provided to start-ups with well-defined business plans. There is no restriction in loan provision with respect to sectors, all agricultural and micro-enterprise activities can avail these loans.

ACAD offers its financial and business support services to low-income Palestinian citizens carrying out various income generating activities. It provides four loan products of sizes ranging from USD 600 to USD 7,500.

The small and micro loans are differentiated on the basis of their respective loan sizes. All the loans are provided in US Dollars and repayments also are also done in US Dollars. For loans of more than USD 3,000, ACAD asks for a guarantor who should be a salaried government employee. This guarantee agreement is also witnessed by the bank which holds the salary account of the guarantor. This allows ACAD to get the salary deducted from the guarantor's account directly from the bank – if needed.

## VII. Islamic Microfinance Products

Selected literatures suggest that Islamic financing contracts could be categorized into four main categories<sup>8</sup>:

1. Sale & Purchase contracts,
2. Leasing contracts,
3. Partnerships (profit and loss sharing) contracts, and
4. Lending/donation contracts.

*Murabaha* (cost plus markup), *Istisna*, and *Salam* (forward contract) fall under the Purchase and Sale contracts category, where an asset can be sold in cash, or in installments, or payments made in advance or at end of the contract.

*Ijarah* (leasing), and *Ijarah Muntahiyah bi Tamleek* (IMBT) (Lease to own) fall under the leasing category where the lessee pays a monthly fee to rent an asset. IMBT includes a promise by the lessor to transfer the ownership of the leased asset to the lessee at the end of leasing contract.

*Musharaka* (partnership) and *Mudaraba* (trustee financing) fall under partnership contracts where both partners provide finance for the project, or one of the partners provides finance and the other provides time and effort.

*Rahn* (collateral) and *Qard Hassan* (zero interest loans) both fall under the fourth category of lending contracts. With *Qard Hassan*, no interest is applied on the loan and in case of default no penalty is imposed on the borrower as it is a loan provided in good faith to support those in need. In case of *Rahn*, a movable asset is kept with the lender as collateral (usually gold).

Islamic microfinance models that have been used so far by MFIs throughout the world often tend to focus on Purchase and Sale contracts as they seem to be the easiest to apply. Within the Purchase and Sale contracts, *Musharaka* financing continues to be the most dominant Islamic microfinance instrument used.

---

<sup>8</sup> Mohammed Khaled, "Building a Successful Business model for Islamic Microfinance", 2011 Global Microfinance summit, Commissioned workshop paper, November 2011.

ACAD added an Islamic product line to its range of conventional products in 2009 by introducing *Murabaha* and *Musharaka*.

These two products defined the target population as all clients engaged in productive economic activities such as agriculture, commerce, services, and manufacturing.

To be eligible for finance, the clients must fit the following criteria:

- 1- Low-income as defined by income is not exceeding more than 150% of the national poverty line.
- 2- The total assets of the micro project should not exceed an amount of USD 10 thousand.
- 3- The number of workers in the microenterprise should not exceed 4 workers.

Table 2- Murabaha's contracts in ACAD

Loan Classification	Loan amount	Payments	Number of installments	Grace period	Minimum profit sharing %
Murabaha /Musana'a	up to 1500	monthly basis	6-18	0-3	NA
Murabaha /Musana'a	2000-3000	monthly basis	6-24	0-3	NA
Murabaha /Musana'a	3500-5000	monthly basis	6-36	0-3	NA
Murabaha /Musana'a	5000-7000	monthly basis	6-36	0-3	NA
Musharaka (sharing)	500-4000	monthly/cy cling basis	6-24	0-3	30%

#### A. *Murabaha*:

*A Murabaha contract refers to a sale contract whereby the Institution offering the Islamic financial service sells an asset, that is already in its possession, to the client at an agreed upon sale price plus profit margin (mark-up). The payment is made within an agreed upon time-frame; usually made by the client through a number of installments but can also be done as a lump-sum payment. The institution bears the risks associated with the goods in possession until they are delivered to the client.*

This is a contract sale between ACAD and its client for the sale of goods at a price which includes a profit margin agreed by both parties. As a financing technique, it involves the purchase of goods by the MFI as requested by its client. The goods are sold to the client with a mark-up. Repayment, usually in installments is specified in the contract.

The key benefit of Murabaha mortgages is that from day one, the property officially belongs to the client; it's registered in his name.

Moreover, ACAD benefits from its long experience of working in the agriculture sector. This is an advantage for ACAD over other MFIs because of its experience in the Islamic lending where information on traders and suppliers is needed.

As illustrated in Table 3, *Murabaha* is the most used form of Islamic financing in ACAD. The number of outstanding clients utilizing Murabaha grew by 18% from 2009 to 2010 and decreased by 6% in 2011 with the introduction of *Musharaka*.

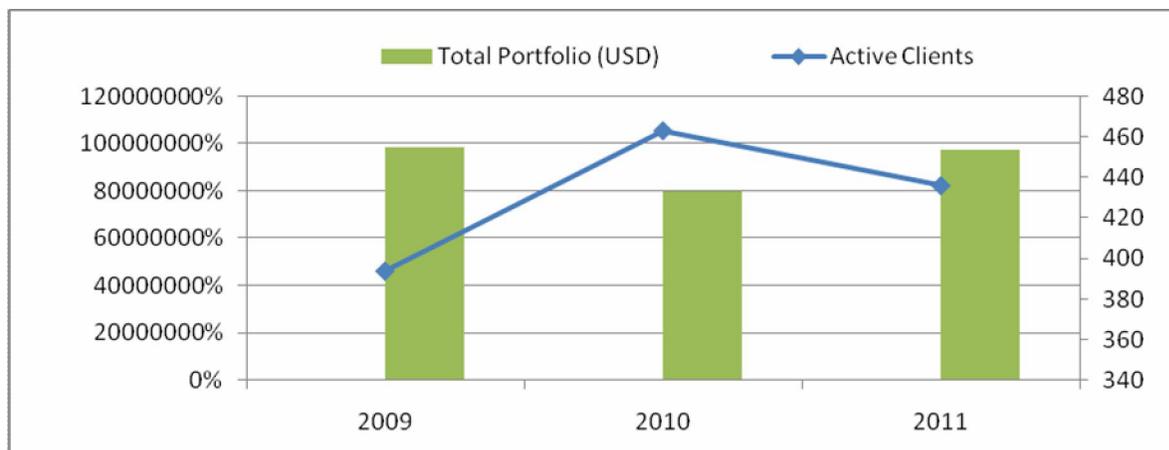
In 2010, the Portfolio at Risk (PAR) has doubled. One year later the quality has been improved to record an evolution of 22% of the portfolio, due to the increase of the outstanding portfolio. Table 3 and Figure 3 illustrate graphically the increase in both outreach and scale over the past three years in *Murabaha* financing at ACAD.

Table 3 – Murabaha in ACAD (2009 – 2011)

Murabaha			
Indicator	2009	2010	2011
Active Clients	394	463	436
Women clients %	41%	36%	36%
Total Portfolio (USD)	988,002	802,181	977,089
PAR > 30 (USD)	32,074	58,563	35,285
PAR > 30 (%)	3.24%	7.30%	3.61%
Total Income (USD)	92,285	166,000	175,000
Volume of <i>Murabaha</i> as % of total Islamic financing	100%	100%	98%

Source: ACAD, December 2011.

Figure 3– *Murabaha* in ACAD (2009 – 2011)



## B. Musharaka

*Musharaka is defined as a partnership contract between the institution offering the Islamic financial service and a customer, to contribute capital to an enterprise, whether existing or new, or for the ownership of a real estate or moveable asset, either on a temporary or permanent basis. Instead of charging interest as a creditor, the institution will make returns through profits generated by that enterprise or real estate/asset which are shared in accordance with the terms of the Musharaka agreement (according to a predetermined ratio). Unlike a creditor, the institution in the Musharaka agreement will share the losses as well, in proportion to each partner's share of capital.*

*Musharaka* was introduced in ACAD in December 2011; the product was funded under Deep program by Islamic Bank for Development. By the end of last year, the number of active clients was 6, with a total outstanding portfolio of USD 25,350.

ACAD enters into a *Musharaka* contract as a partner with the client; it agrees with the client on needs, the process of financing purchases, and follows-up with the client on implementation and participates in project evaluation. Visits are conducted on a monthly basis for the purpose of follow-up and delivery of administrative services for the project. *Musharaka* product financed existing agricultural projects seeks for development, mainly, greenhouses and livestock projects. The profit distributed in proportion to each partners' share of capital, as the partnership agreement; each partners' share is 50% in most cases.

Some of the benefits ensuing from a *Musharaka* agreement for the client are ACAD's experience in sourcing supplies (usually the best quality materials) and from bulk discounts through ACAD's links with suppliers. On the other hand, ACAD benefits by ensuring that the project is run with the best possible inputs, thereby reducing the risk of business failure. Pipelining of loans, phantom loans and wrong loan utilization are kept at a minimum through this Islamic method of financing.

According to ACAD the challenges is related to following-up with micro-entrepreneur regarding their income and expenses, as well as, the need for trained and experienced employees in the fields of the projects in order to be able to understand and follow up with the clients.

According to ACAD, the advantages of such a product is the clients prefer partnership agreements as a profit and loss sharing agreement that doesn't oblige them to payback if they did not make profits. Moreover, for the MFI, in some cases the profit generated from the partnership agreement is much higher than the profit generated from other Islamic or conventional product due to the fact that sharing the profits in cases is much higher than taking a pre-determined rate.

## VIII. ACAD's Financial Performance

### C. Financing Sources

ACAD's main source of funds continues to be grants. The MFI received its first loan in 2006 from the Islamic Development Bank (IDB) for USD 200,000 and tenure of four years. By the end of the fourth year of the loan's duration, that is, in 2009, ACAD received another loan of USD 900,000 from the IDB at a rate of 2% per annum. In 2008, ACAD had also received an interest free loan of USD 164,000 from the French Agency for Development (AFD). As of December 2010, ACAD had a Capital Adequacy Ratio (CAR) of 57%.

Figure 4– ACAD's funding structure 2010

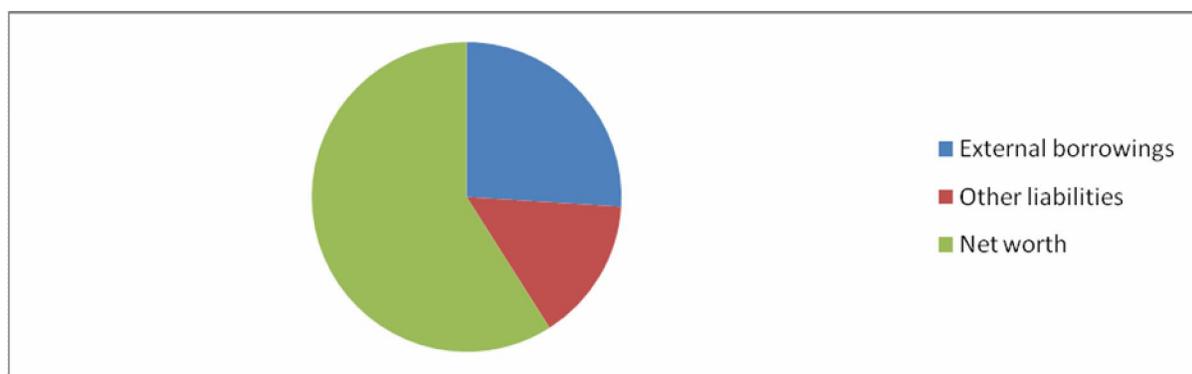
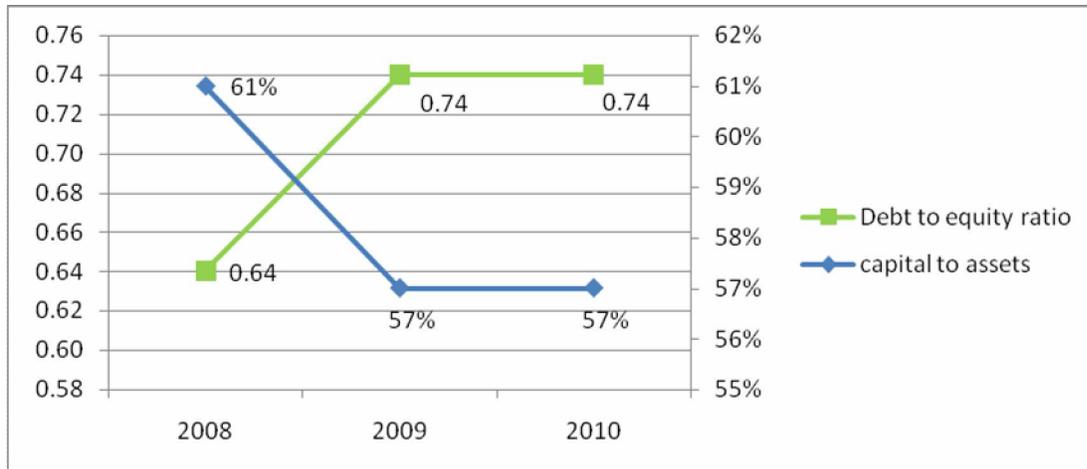


Figure 5 – ACAD's financing Sources (2008 - 2010)



Source: MIX Market data, 2008-2010

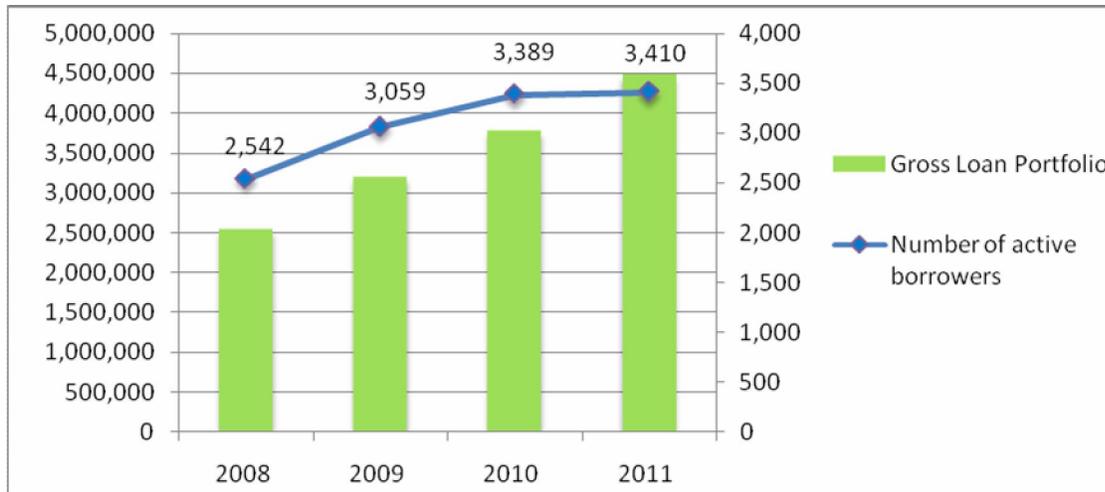
#### D. Outreach

ACAD's expansion strategies have been greatly influenced by the external environment and funds availability for the period 2005-2010, ACAD didn't witness any growth in its outstanding portfolio, mainly because of fund constraints. In 2006, after Hamas (political group) was voted to power, foreign aid dried out and ACAD's portfolio fell as a result by 28%. The portfolio again grew and reached earlier levels of USD 3.6 million by the end of December 2010.

On the other hand, there has been a shift in ACAD's strategy to focus on relatively smaller sized loans to women. This strategy was adopted in 2007 and it aimed at (1) targeting more low income families in Palestine and (2) reducing the credit risk associated with larger sized loans. The Women Loan product was introduced in 2007 and the *Murabaha* loan was introduced in 2009.

The share of women's loans and Islamic loans in the portfolio, as of December 2010, gone up to 51.6% and 31.7% of the portfolio respectively, since their introduction in 2006/ 07. This is an indicator of the high demand for these loans and their relevance for the target clientele. Moreover, the introduction of these new products led to an increase in the number of loan clients from 1,283 as of 31 December 2005 to 3,389 as of 31 December 2010, a 31.54% increase. The average loan size also fell from USD 2,578 as of 31 December 2005 to USD 1,110 as of 31 December 2010, a significant reduction of 57% which was in line with the MFI's new strategy as outlined earlier.

Figure 6– ACAD's Outreach 2008- 2011



Source: MIX Market data, 2008-2010. ACAD, 2011

### Islamic versus conventional microfinance portfolio year end 2011

As indicates in Figure 7, Islamic lending represents a small percentage of outreach. *Murabaha* serves only 18% of the target population and constitutes only 11% of the total portfolio; while *Musharaka*, as noted before, is still in its launching period.

Table 4 – ACAD Islamic services Scale 2011

Outreach	Conventional Microfinance	Islamic Microfinance
Total # clients of financing products	3,410	442
Total financing outstanding (\$)	4,466,920	1,002,439

Figure 7– ACAD Islamic services Scale 2011

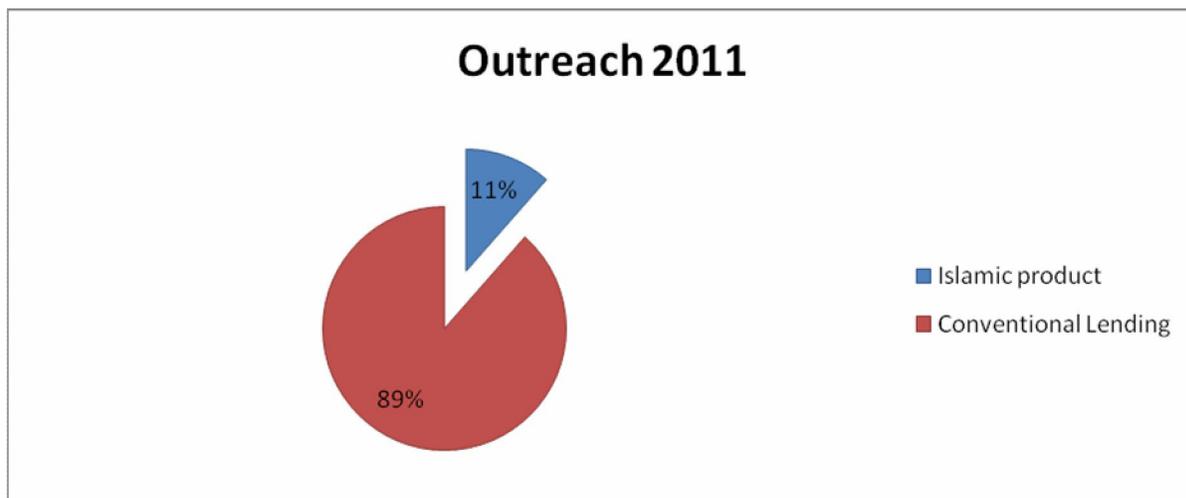
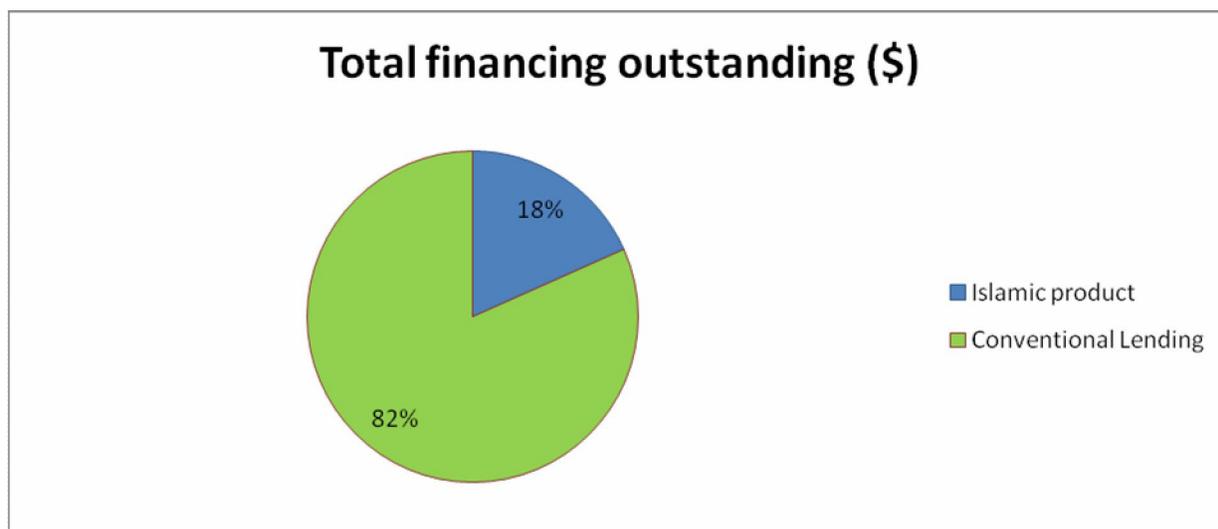


Figure 8–Total financing outstanding 2011



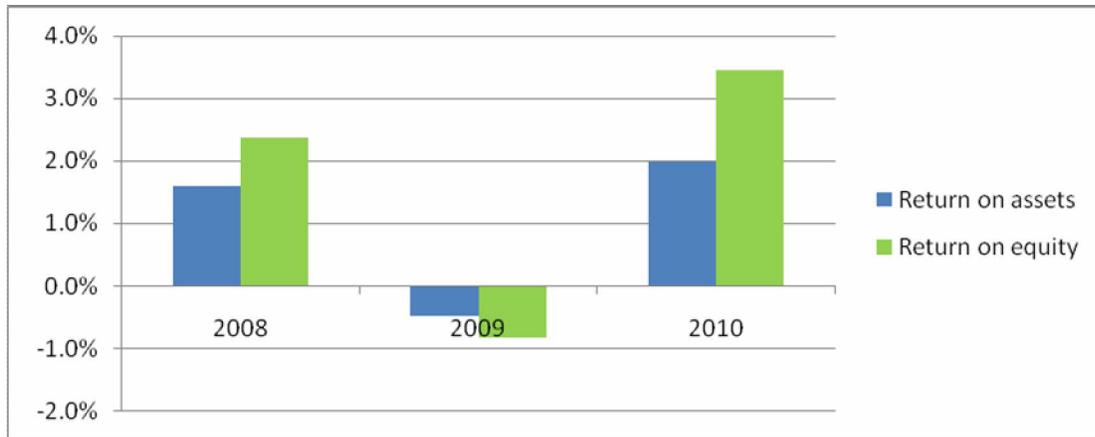
### E. Profitability

ACAD has shown a much improved performance on profitability and sustainability over the last three years. ACAD's Return on Asset (RoA) has increased from – 20.5% in 2006 to -0.5% in 2009. In 2010, ACAD started generating revenue and covering its operating expenses. The RoA is positive and recorded 1.97% as shown in the chart below. The revenue generated from Murabah, the major Islamic product, is participating by 21% of the total interest and fees income for 2010.

For the year ending 2010, the Operational Self Sufficiency (OSS) was reasonable at 112.2% however, the Financial Self Sufficiency (FSS) remains low understandably low because of dependence upon subsidized funds and grants.

As part of its efforts toward transformation to a sustainable MFI, which includes, shifting focus to women loans, reducing the loan sizes, decentralization of operations, performance linked incentive system for the staff, and an automated and networked Management Information System (MIS) ACAD also plans to change its legal structure from an NGO into a not-for-profit company.

Figure 9– ACAD's Profitability 2010

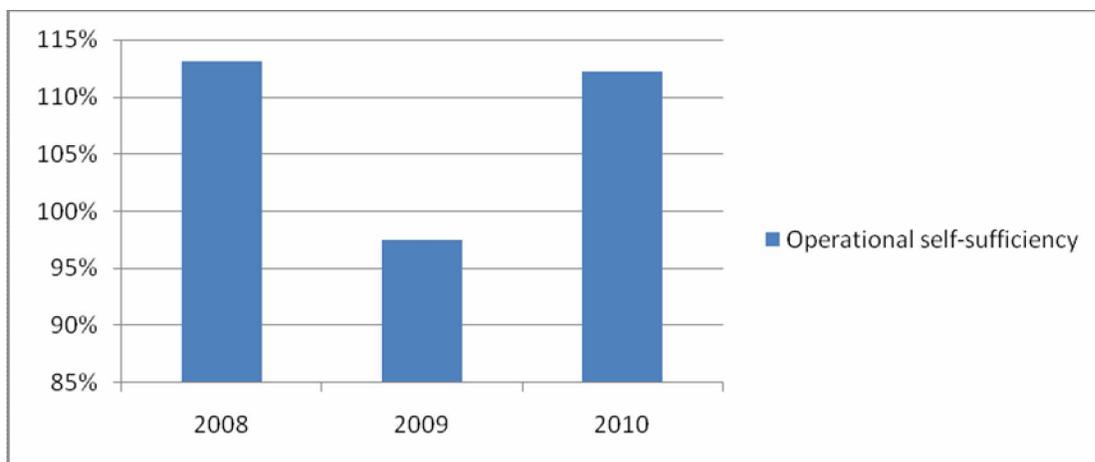


Source: MIX Market data, 2008-2010

### F. Productivity and efficiency

The productivity of ACAD staff is growing with a clients to total staff ratio of 79 and client to credit officer ratio of 169. The number of field staff increased during the last five years due to opening of new branches; however, these numbers remained stable over the 3 last years. The loan officer productivity ratio declined is growing from 2009 to 2010 by 55% due to the increase of client number, and loan process reduction by the new MIS system.

Figure 10– ACAD’s Operational Self- sufficiency



Source: MIX Market data, 2008-2010

The staff productivity in terms of loan outstanding is increasing because of the growing number of clients. During this 3 last years, ACAD chose to grow with the same number of branches by improving penetration which is expected to bring greater efficiencies.

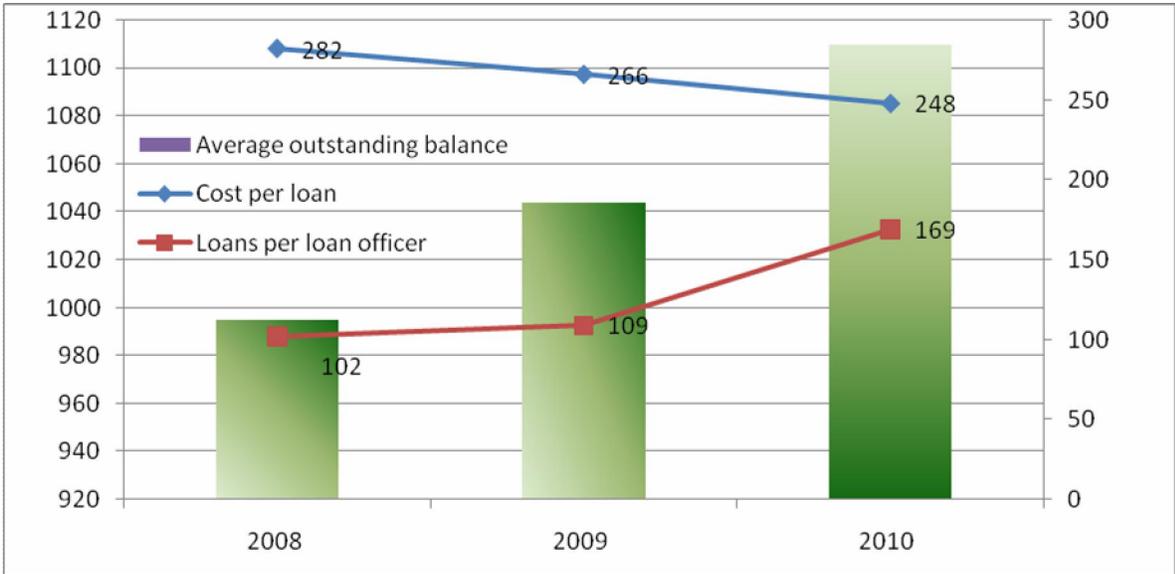
Table 5 – ACAD’s productivity & efficiency indicators (2009 – 2011)

Indicator	2008	2009	2010
Average outstanding Balance	995	1044	1110
Cost per borrower	282	266	248

Cost per loan	282	266	248
Borrowers per staff members	64	70	79
Borrowers per loan officer	102	109	169
Loan per loan officer	102	109	169

Source: MIX Market data, 2008-2010

Figure 10– ACAD’s efficiency 2010



Source: MIX Market data 2008-2010

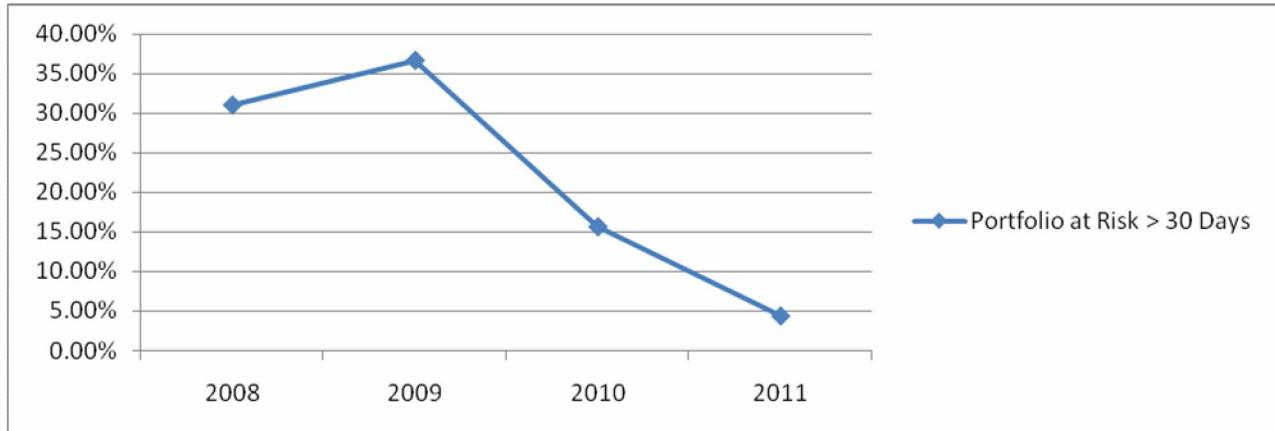
As illustrated in figure 10, with an increase in the average size of portfolio, the operational efficiency can be expected to improve further in the medium to long term.

The computerized, integrated and online system has a good impact on the productivity and efficiency of the whole process. The system provides access to information on their respective clients to the branches on a real time basis, which reduce the time of the loan approval, follow up and overdue tracking.

### G. Portfolio quality

The political and economic crisis affected ACAD's portfolio quality throughout the period from 2007 to 2010 when PAR began improving to reach 15.6%, compared to a median of XX% in Palestine. The political and economic instability impacted the clients' ability to repay and the overall control environment which has inevitably affected ACAD's portfolio quality. Moreover, ACAD rescheduled 10.4% of its total outstanding loans in December 2009. The low yield, which was mainly due to low repayment rate, was not even sufficient to cover operating expenses. In December 2011, the portfolio quality improved to reach the lowest PAR rate since 2005; namely, PAR>30 days of 4.32%. ACAD still does not apply any write offs policy.

Figure 11– PAR in ACAD 2010



Source: MIX Market data 2008-2010. ACAD 2011.

Figure 12– Portfolio quality in ACAD 2008 - 2010



Source: MIX Market data 2008-2010.

#### H. Client impact

ACAD is a member of the Palestinian Network for Small and Micro Finance Institutions (“Sharakeh”) which conducts market researches for all its MFI members, as part of its several activities. Recently, an impact assessment study was conducted covering clients of 5 partner MFIs (287 clients in all, which included 11 of ACAD’s clients). While the analysis is detailed and well presented, the small sample size poses a problem, especially for ACAD. Furthermore, in most of the questions, only 8-9 clients have responded. However, in terms of positive impact, 6-7 clients have consistently cited positive impacts of the loans on their businesses as well as their quality of life (access to better education, improved health facilities, etc.).

In the future, it is advisable for ACAD to use the data in its application forms to build a baseline for comparison. It can then undertake low-cost internal impact studies with proper sampling techniques, in

order to compare changes and results over time. Around 49% of ACAD's clients are new (joined in 2009) and it would be advisable to build a baseline using their data as it is easily accessible.

### I. Transparency

According to the social rating done in 2010, ACAD is fairly transparent in its dealings with clients. The loan contract does not declare the Effective Interest Rate (EIR) to clients, but includes the total amount of interest (and interest equivalent on Islamic loans) so that clients know how much they are being charged for the financial services availed. Branch staff and appointed lawyers (who notarize the guarantor's and client's documents at the time of loan sanction) reiterate loan terms and conditions before the contracts are signed.

For those clients who cannot read, the entire contract is read out aloud to them by the lawyer. Clients have a copy of the loan contract and repayment schedule. They receive receipts from the bank for their repayments.

### J. Cost to clients

The annual Effective Interest Rate (EIR) for women's and micro loans ranges from 33-34%. Since the grace period is chosen by clients, the EIR varies a little between loans. The EIR includes an upfront fee of 1% of the loan amount as administration fee, charged by the partner banks. EIR on Islamic and small loans is much lower at 14.5% and 14.6% p.a. respectively.

ACAD charges a flat rate of interest on most of its loans, except higher amounts under Islamic loans and small loans. Interest calculation and generation of the repayment schedule are automated in the new MIS to avoid human errors.

ACAD would like to further reduce cost to clients, in keeping with their feedback. However, its charges in comparison with the other financial institutions in Palestine are almost the same. ACAD faces competition from banks which are able to lend at lower rates of interest (9-12% p.a.) as illustrated in table 6 below.

Table 6 –Cost to client benchmarking

Cost structure as % of average portfolio	ACAD	Palestine	Middle East and North Africa
Av. Outstanding loan (USD)	1,023	2,512	606
Clients/ field staff	146	136	153
Operating expense ratio	24.5%	17.1%	15.1%
Financial expense ratio	1.3%	0.0%	6.2%
Loan provisioning	1.1/5	1.0%	1.0%
Total Costs	26.9%	18.1%	22.4%
Yield	-2.2%	-1.7%	9.4%
PAR > 30 days	27.0%	29.0%	2.4%
Write-off	1.8%	0.0%	0.2%

Source: ACAD social rating report 2010 - (Dec 09 – ACAD, Dec 08 for Palestine and MENA)

### K. Client feedback

As mentioned in its last social rating report, ACAD clients said that they prefer ACAD to banks and other MFIs because of the easy access to loan, and good relationship with staff, convenient product terms and conditions and quick loan processing.

ACAD's Islamic loans and women's loans exclusively handled by women staff have made its products popular and helped it to compete with banks and other MFIs.

Other responses included that ACAD supports women, interest is lower than other providers, guarantor requirements are fewer than other providers, and that Islamic loans are in line with religious principles and ACAD's repayment schedule is suitable

Clients interviewed during the survey conveyed the following feedback and suggestions for improvement:

- Around 56% of the respondents said that they did not have any negative feedback about the program.
- Other feedback included that depositing and cashing of cheques in the bank is difficult, the documentation is excessive, and that clients should not have to bear the currency risk, and that collection of interest is not permitted under Islam.
- High rate of interest and low loan amounts seemed to be the main concerns for clients, many of whom reiterated in their suggestions for improvement that ACAD should lower interest rates and/or raise loan amounts.

Projections 2012-2014:

Indicator	2012	2013	2014
Number of branches	8	9	9
Number of staff	42	48	60
Total # clients of financing products	4250	5300	7500
Total financing outstanding (\$)	5,500,000	7,000,000	10,000,000
Ratio of total Islamic financing to overall financing	35%	50%	50%
Total net income from operating/Islamic financing activities (\$)	1,500,000	2,000,000	3,000,000
Total net income from non-financial activities (\$)	80,000	120,000	200,000
Total # depositors	-	-	-
Total deposits (\$)	-	-	-
PAR>30 days			
New products	2	5	5

L.

## IX. Lessons Learned from ACAD Case Study and Recommendations for Successful Design and Implementation of Islamic Microfinance Models:

1. Islamic finance products are diversified and have the versatility of reaching different target groups with diverse needs. With innovative ways of implementing Islamic microfinance contracts and products, most of the clients' needs could be met; it all depends on product design. ACAD's products are diversified in the sense of catering products according to the geographic distribution of clients. Furthermore, ACAD has long experience of working in the agriculture sector which considers an advantage over other MFIs offering Islamic lending, where information on traders and suppliers is used to provide the Islamic MF clients with the best prices for the products for their business especially in *Murabaha* contracts.
2. Keeping the double bottom-line concept in mind, social responsibility and impact is inherent in Islamic financing models. In fact, *sharia* compliance is often synonymous with social responsibility and client protection by focusing on productive activities rather than monetary transactions and ensuring that the client is not taken advantage of under any contractual agreement. This is an important lesson learned for those considering an investment that yields financial and social returns. While with conventional microfinance, social impact must be deliberately considered in the design and provision of conventional microfinance products; social impact is indeed embedded within the design of Islamic microfinance products and is a key to their success from the start.
3. Following up with the clients in the field is a contributed factor for ensuring the success of the Islamic contract implementation, in order to be able to understand and follow up with the clients. ACAD has trained their staff to perform on-site support to the clients and provide them with the needed technical advices if required.
4. Providing *Sharia* compliance products is crucial for the clients' acceptance of the MFIs products, in *Musharaka* contracts, clients prefer partnership agreements as a profit and loss sharing which doesn't oblige them to payback if they did not make profits. As for the MFI, in some cases the profit generated from the partnership agreement is much higher than the profit generated from

other Islamic or conventional product due to the fact that sharing the profits in cases is much higher than taking a pre-determined rate.

5. Given the constraints in its operating environment, ACAD has shown progress in various aspects of financial and social performance, including good outreach to rural clients and women, product design in keeping with the needs of its target clientele, and provision of a variety of non-financial services.
6. Supporting clients through using non-financial products and services to improve their lives. ACAD believes that the organization has an inherent social mission as well and thus, along with the financial products.
7. Increased regulation and supervision will help to formalize processes. The new organizational form will enable ACAD to raise equity for its future expansion. Another priority during the current period of stability is improvement of portfolio quality, for which incentives have been designed and efforts are underway. ACAD is in the process of consolidating its operations to achieve financial stability.
8. The introduction of the Islamic mode of financing could help ACAD to meet its core objective of poverty alleviation, increased production, and job creation. However, in order to better meet clients need and realize permanence of its activities, a market study, and clients' surveys should be conducted for an adequate analysis of clients' needs and perceptions toward such a change in financing mode, to avoid any sudden deterioration in the portfolio.

## X. References

- CGAP, Sanabel, and Al Baraka Banking Group, "Islamic Micro, Small, and Medium Enterprise (MSME) Finance Survey", 2011.
- Khaled, Mohammed. "Building a Successful Business model for Islamic Microfinance", 2011 Global Microfinance summit, Commissioned workshop paper, November 2011.
- MIX Market. "2010 Arab Microfinance Analysis and Benchmarking Report". 2011.
- ACAD-2010 M-Cril social rating report
- ACAD-2010 M-Cril financial rating report
- Micro-Watch Report as of September 2011
- ACAD Audit report for 2010
- ACAD profile in the Mix Market Website
- ACAD brochure
- Mohammed Obaidullah. " Introduction to Islamic microfinance".

## XI. Appendixes

### Abbreviations and Acronyms

ACAD	Arab Center for Agricultural Development
ASALA	The Palestinian Businesswomen's Association
CGAP	Consultative Group to Assist the Poorest
FATEN	Palestine for Credit and Development
ILO	International Labour Organization
MFI	Microfinance Institution
NGO	Non Governmental Organization
PARC	The Agricultural Development Association
PDF	Palestinian Development Fund
PECDAR	Women's Fund
PMA	Palestinian Monetary Authority
SANABEL	Microfinance Network of Arab Countries
SME	Small and Medium Enterprise
UNDP	United Nation Development Program
UNRWA	United Nations Works and Releif Agency