Is Too Much of a Good Thing a Bad Thing?

By Bishara Dabbah

Currently, 13 banks are operating in the State of Palestine: 4 Palestinian commercial banks, 3 Palestinian banks that comply with Islamic Sharia law, 5 banks registered in Jordan, and 1 Egyptian bank. Palestinians thus have access to banking services from 379 branches spread throughout the West Bank and the Gaza Strip. All 13 banks fall under the control and supervision of the Palestine Monetary Authority (PMA).

But even though the Palestinian market is thus considered overbanked, with too many banks competing over a limited amount of business, the financial inclusion ratio in Palestine at the end of 2016 was only slightly over 35 percent. This means that after more than 20 years of banking, 65 percent of Palestinians in Palestine still have not opened a bank account and have no access to banking services.

Table 1: Banking entities subject to PMA control and supervision at the end of 2020[i]

Year established	Local Banks	Branches
1960	Bank of Palestine	74
1995	Palestine Investment Bank	21
1995	Al Quds Bank	39
1996	Arab Islamic Bank	27
1997	Palestine Islamic Bank	45
2006	The National Bank	37
2016	Safa Bank	9
Total	**7 Banks**	**252**
Year established	**Foreign Banks**	**Branches**
1994	Arab Bank	33
1986	Cairo Amman Bank	22
1995	Jordan Ahli Bank	10
1994	Bank of Jordan	40
1994	Egyptian Arab Land Bank	7
1995	Housing Bank	15
Total	**6 Banks**	**127**

The PMA has therefore taken serious steps to increase financial inclusion, which would increase customer deposits and net direct credit facilities, secure a higher consolidated net income for banks, and, most importantly, promote economic expansion, raise the per-capita income, and lower unemployment levels. Jordan faced the same situation of low levels of financial inclusion in the past. But the Central Bank of Jordan, in cooperation with the banking sector and the Association of Banks, has succeeded in improving this ratio to slightly above the 50 percent level.

Table 2: Aggregated Financial Position for Banks, 2019, 2020, 2021 (figures are rounded to the closest US$ million)[ii]

	2021	2020	2019	2-year growth
Net cash balances	7,042	6,050	5,046	40%
Net direct credit facilities	10,310	9,690	8,749	18%
Total Assets	**20,735**	**18,703**	**16,989**	**22%**
Customer deposits	16,494	15,110	13,366	23%
Total Liabilities	**18,773**	**16,924**	**15,211**	**23%**
Total Owners' Equity	**1,962**	**1,779**	**1,778**	**10%**
Total Liabilities and Owners' Equity	**20,735**	**18,703**	**16,989**	**22%**

Table 3: Aggregated Income Statement for Banks, 2019, 2020, 2021 (figures are rounded to the closest US$ million)[iii]

	2021	**2020**	**2019**	**2-year growth**
Interest Income	712	636	655	9%
Interest Expenses	127	124	131	(3%)
Net Interest Income	**585**	**512**	**524**	**12%**
Net Commission Income	115	104	117	(1%)
Total Revenues (excl. provision recovery)	**806**	**689**	**722**	**12%**
Total Expenses (excl. provision expense)	487	451	462	5%
Provision Expense (net of recoveries)	64	99	61	5%
Net Profit for the Year	**185**	89	156	19%

To study the growth rate of the banks' positions and incomes, a comparison of the years 2021 and 2019 gives more accurate results because in 2020, the COVID-19 pandemic extensively affected the banks' financial results. Banking activities went back to normal in mid-2021. Obviously, all financial indicators for the banking sector have improved over the past two years in rates that indicate a strong economic turnaround for the banking sector.

Table 4: Banking Industry Financial Indicators[iv]

	2021	**2020**	**2019**
Net Interest + Commissions/Total Revenues	87%	89%	89%
Return on Assets	0.9%	0.5%	0.9%
Return on Equity	9.4%	5.0%	8.8%
Customer deposits/Total assets	80%	81%	79%
Net direct credit facilities/Total assets	50%	52%	52%
Net direct credit facilities/Customer deposits	63%	64%	66%
Net income (in US$ million)	185	89	156
Total owners' equity/Total assets	9.5%	9.5%	10.5%

The Palestinian banking sector is simultaneously facing challenges and presenting opportunities. A main challenge is that Palestinian banks must operate under an unusual set of circumstances. They have to cope with the negative impact of the Israeli occupation and must operate while mitigating the absence of a Palestinian currency, the lack of country ratings, a weak legal structure, and a relatively small economy that is based on consumption rather than production. Thus, working conditions are much more difficult for Palestinian banks than for banks that operate in sovereign countries.

Moreover, Palestinian banks must work with three currencies, namely the US dollar, the Jordanian dinar (JOD), and the Israeli shekel (NIS), which creates risks in terms of foreign exchange, volatility, and balance-sheet conversion. The matching of assets and liabilities in each of these currencies is a lengthy and difficult task. The inability to cover their currency position exposes the banks to risks that may have serious consequences. For example, statements are reported in US dollars, whereby, according to the accountant rules and principles, JOD and NIS are converted into dollar figures based on the current exchange rate. This may create net losses for the banks.

Banks are in a position similar to anyone else in Palestine, as the occupation interferes in every aspect of our lives and movement restrictions also affect financial transactions. For example, the transfer of cash between head offices and branches requires obtaining clearance from the Israeli side, and Israeli companies must be utilized to carry out transfers between cities because Palestinians have no security control in the so-called areas B and C. The fees charged by these companies are high and add to the cost of funds; ultimately, the borrowers pay for them.

Among the most serious challenges faced by the banks that operate in Palestine is the inefficient legal system. Simple disputes take years to resolve. For banks, an inefficient legal system is major risk for two main reasons. The first involves the computation of provisions by the banks. Provisions are the legal requirement to write down the value of an asset when the collection is uncertain, regardless of the presence of collateral. According to the rules of the PMA and the International Financial Reporting Standards (IFRS), collaterals have no relevance after five years when it comes to provision calculation. This means that a bank that does not gain ownership of the collateral within five years of nonpayment must accept a 100 percent loss of the loan amount. High provisions therefore lead to lower net incomes and may lead to bank closures. The second effect of the slow legal process is that the value of the collateral will continue to decline over time, as cars and real estate depreciate every year. Stocks and bonds held by a bank as collateral may see fluctuation or even major reductions in their market price. Therefore, the prevailing weak and inefficient legal structure and the lack of law enforcement in Palestine

have caused banks to slow the lending. They tend to lend only to a certain class of borrowers and in limited economic sectors.

On the positive side, we can ascertain that Palestinian banks offer comparatively low-risk investment opportunities. One of the best-known definitions for risk involves the volatility of net income, the return on assets, and the fluctuations in all other financial indicators. Most of the financial returns and net-income indicators for the 13 banks that operate in Palestine have been improving at a constant rate since the height of the pandemic, and the returns on assets and equity have remained steady (see Table 4: Banking Industry Financial Indicators). Viewed from this angle, the Palestinian banks, like the industry in general, give investors a space for comfort and take away reasons for concern.

The efficiency of Palestinian banks leaves much room for improvement. Efficiency in a banking system is described as the ratio of expenses to total revenues. The higher the ratio, the weaker and more at risk the bank. Some experts include provisions in the total expenses whereas others omit them. I will omit the effects of provisions in my analysis to render it more credible and avoid unnecessary arguments.

Table 5: Aggregate Efficiency for Banks Operating in Palestine (all figures are in US$ million)[v]

	2021	2020	2019
Total Expenses	556	555	531
Less Provisions (exp)	69	104	69
Net Expenses	487	451	462
Total Revenues	811	694	731
Provision Recoveries	5	5	8
Net Revenues	806	689	723
Efficiency Ratio (excluding provision)	60%	65%	64%
Efficiency Ratio (including provision)	69%	80%	73%
Arab Bank Efficiency Ratio (excluding provisions)	51%	53%	46%
Arab Bank Efficiency Ratio (including provisions)	58%	63%	51%

The principles of best practice for banking stipulate that banks maintain the expenses-over-revenues ratio at a maximum of 50 percent. Regardless of the calculations used to obtain the ratio, banks in Palestine clearly incur very high expenses relative to the tasks and revenues generated. Of the 13 banks that operate in Palestine, Arab Bank continues to be the most efficient bank with the lowest expenses as a percentage of revenues.

Table 6: Aggregate vs. Arab Bank Branch Efficiency (in US$ million)[vi]

Total Assets	**2021**	**2020**	**2019**
Aggregate for Banks: Total Assets/Branch	58.9	53.6	48.3
Arab Bank: Assets/Branch	140.6	134.9	122.6
Arab Bank/Aggregate	239%	216%	254%
Customer Deposits	**2021**	**2020**	**2019**
Aggregate for Banks: Customer deposits	46.9	43.3	38.0
Arab Bank: Customer deposits	115.4	108.2	101.7
Arab Bank/Aggregate deposits	246%	250%	268%

Banks can revisit their expense structure to bring their efficiency ratios more in line with best practice. The more efficient use of resources will definitely permit banks to offer their services to customers with a lower interest margin. Moreover, it will increase the demand for loans and help the economic growth of the Palestinian economy.

Table 7: Aggregate Effectiveness for Banks Operating in Palestine (in US$ millions)[vii]

Economic Sector	**Sept 30, 2021**	**%**
Total Public Sector	2,374.3	22.7%
Real Estate and Construction and Land Development	2,223.0	21.2%
Mining and Manufacturing	550.8	5.3%
Local and Foreign Trade Finance	1,676.9	16.0%
Agricultural and Food Processing	131.1	1.3%
Tourism, Hotels, and Restaurants	91.0	0.9%
Transportation	28.5	0.3%
Business and Consumer Services	1,046.5	10.0%
Securities Purchasing and Carrying	106.7	1.0%
Consumer, Vehicles and Other Persona; Finance	2,245.0	21.4%
Total	**10,473.9**	1

The major criticism directed at the banks that operate in Palestine addresses the sectoral distribution of loans. While a total of US$10,479 million was on loan on September 30, 2021, the banks' aggregated loan portfolio showed that public sector loans (22.7 percent), real estate loans (21.2 percent), and consumer loans (21.4 percent) accounted for US$6,842.3 million (or 65.3 percent) of this loan portfolio. However, loans for projects in agriculture (1.3 percent), tourism (0.9 percent), transportation (0.3 percent), and manufacturing (5.3 percent) accounted only for US$801.4 million (or 7.8 percent). It is therefore obvious that loans are not geared towards supporting the productive sectors, reducing unemployment, or expanding the economy and the GDP. Rather, they are consumer-based in nature. But the latter loans bring in good return to banks, compared to the relatively low risk they pose for them. Thus, from the banks' point of view, the systematic risks in the Palestinian economy dictate this type of a lending portfolio in order to generate revenues and keep customer deposits safe. It remains unclear what steps the PMA as regulator should take to shift banks' lending to the productive sectors in the economy while maintaining low risks for the lenders and safeguarding the best interest of depositors.

The PMA's stated mission to "foster economic and monetary stability and contribute to economic growth" would be tremendously served by changing the sectoral mix and extending more loans and banking facilities to the economic sectors. Such lending could produce jobs, provide strategic foodstuffs and services, protect our foreign currency reserves by reducing imports, and generate a higher GDP and more economic growth.

To answer the initial question that serves as the title of this article: "Is too much of a good thing a bad thing?" I reply that in (not only) my opinion, Palestine is currently over-banked, and the number of banks needs to come down in order to help banks improve their efficiency and move towards a more productive type of competition. Again, the PMA has done a great deal of work in this area by encouraging mergers and acquisitions (M&A) among the banks. In the early 2000s, 21 banks operated in the occupied territories; today, this number stands at 13. The PMA's guidelines to increase the minimum capital for banks from the initial US$20 million to US$75 million helped in the M&A of banks. Thus, the presence of fewer banks will reduce the overall expenses in the banking sector and bring the expenses-over-revenues ratio closer to international standards.

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[i] Annual Report 2020, Palestine Monetary Authority (PMA), pg. 9, available at https://www.pma.ps/en/Publications//AnnualReports.

[ii] Financial Position of Banks (reports for the years 2019, 2020, and 2021), Association of Banks in Palestine, (the figures are presented in each report on pgs. 6).

[iii] Ibid. (p. 7).

[iv] Ibid. (p. 8).

[v] Ibid. (p. 7).

[vi] Ibid. (p. 8).

[vii] Third-Quarter Report 2021 (in Arabic), PMA, available at chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.pma.ps/Portals/0/Users/002/02/2/Publications/Arabic/%D8%AA%D9%82%D8%A7%D8%B1%D9%8A%D8%B1%20%D8%B1%D8%A8%D8%B9%D9%8A%D8%A9/%D8%A7%D9%84%D9%86%D8%B4%D8%B1%D8%A9%20%D8%A7%D9%84%D8%A5%D8%AD%D8%B5%D8%A7%D8%A6%D9%8A%D8%A9%20%D8%A7%D9%84%D8%B1%D8%A8%D8%B9%D9%8A%D8%A9/PMA%20-%20Quarterly%20Statisitical%20Bulletin.pdf?ver=2021-11-03-142126-100.