# Palestine Monetary Authority

# Financial Stability Report
# 2009

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Palestine Monetary Authority

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# Executive summary

The global economy in 2009 demonstrated many indicators of positive retraction towards recovery, although the financial crisis continues to cast a shadow over the global economic activity. International economic indicators issued by the International Monetary Fund (IMF) indicate that the percentage of decline in the global product amounted to 0.6% by the end of 2009, a much less horrifying than the initial IMF expectations at the beginning of the year, when IMF projected a decline of 1.1% in global product. This upturn in the growth prospects of the global economy came as a result of the outcome of the positive and increasing growth achieved by the developing and emerging countries, unlike the case in the advanced economies, which are still suffering from recession.

This recession has led to a decline in inflation rates in most countries of the world in 2009. Oil prices dropped from record levels of about 141 dollars per barrel of crude oil in 2008 to 33 dollars at the beginning of 2009. Unemployment rates also increased. Prices of precious metals, most prominently gold, maintained their rising trend this year, in a continuation of the phenomenon of the continuous rise in the price of such metals for many years now. The average price of an ounce of gold (in U.S. dollars) hit a record increase of 11.5% compared to 2008.

On the other hand, the U.S. dollar regained in 2009 some of the value it had lost over the past two years. Exchange rates of the dollar against the other major currencies indicate an improvement in its exchange rate, particularly against the Euro, the Japanese yen, as well as the Israeli shekel. The dollar's exchange rate increased by about 1% against the Euro and about 3% against the Japanese yen, while it rose by 9.5% against the Israeli shekel in 2009 compared to the previous year. With regard to interest rates on the major global currencies, they have shown considerable stability with no significant changes during 2009. They remained low compared to previous years, which reflected the need to boost the economic growth again.

With this relative improvement in the global economy, the risks threatening the financial stability were mitigated. The credit problem is heading towards a solution, accompanied by a relative easing of the strict requirements with respect to the bank lending standards. Credit growth rates have been increasing in many developing and emerging economies. However, there are still significant risks facing the global financial stability. Demand for credit in some economic sectors continued to suffer from difficulties, especially in the developed countries. The question of significant accumulation of public debt in the countries of the world is still in bad need for strategies to address and control them, and to address the imbalance in the financial sector. This will allow for maintaining the developmental monetary policies without any inflationary pressures or causing instability in the financial markets.

As regards the financial and banking stability in the Palestinian territory, and how far it was affected by the global financial crisis, Palestine was one of the countries least affected by this crisis. This is due to the limited opening of the Palestinian economy to world's economies, the juvenility of the Palestinian banking system and its dependence mainly on traditional financial instruments, and the juvenility of the Palestine Securities Exchange and being limited to trading in one type of securities, namely, the equity shares of listed companies, in addition to the economic and political restrictions imposed by the Israeli occupation.

All the above factors helped mitigate the negative impact of the financial crisis in general. However, some Palestinian banks incurred investment losses with Lehman Brothers, but in total they did not exceed the amount of two million dollars. The incident entailed a review of the directives on the management and regulation of investments abroad. New controls on investment at the state, financial institution and currency levels were introduced. In addition, investment in derivatives was strictly restricted except for hedging purposes.

At the level of the Palestinian Securities Exchange, the market experienced a significant decline in stock prices during the initial period as a result of panic and uncertainty that prevailed among investors because of the collapse of major firms in the global financial markets. However, by time, and as a result of the achievement of positive results by listed companies in the financial market during 2009, stock prices returned to normal.

It can be argued that the implications on the real Palestinian economy are divided into negative and positive effects. The main source of such effects is mainly the unavoidable correlation of the Palestinian economy with the Israeli economy. The positive effects are represented in the decreasing levels of global prices and declining inflation. The inflation rate plummeted in the Palestinian territory from 9.9% in 2008 to 2.8% in 2009, which reflected positively on the purchasing power of the Palestinian people. The negative effects are represented in the declined of current transfers by approximately 25.8% in 2009, due to the decline in official transfers, which experienced a state of volatility and instability. The volume of grants and foreign aid fell down in 2009 by more than 20% compared to the previous year, with their total amounting to 1413 million dollars.

Exports of goods and services also declined by 7.8% though it was presumed that the declining value of the Shekel against the dollar should contribute to improving the competitiveness of the Palestinian exports. However, as the Israeli economy was affected by the global financial crisis, such exports have substantially declined.

The economic improvement witnessed by the Palestinian territory in 2009 and the continued efforts by the Palestinian government to establish the bases of good governance, increased transparency and accountability had an evident impact on improving the financial conditions of the Palestinian Authority this year. There was considerable improvement in the performance of the Palestinian government during 2009. The value of the total net domestic revenues increased by 1.9%[1], due to increased tax and non-tax revenues (excluding extraordinary items). On the other hand, the total public expenditure was reduced by more than 5% in 2009, compared to the previous year. The expenditure reduction is attributed to the public spending rationalization policy

[1] For the purposes of comparison, incidental revenues received for a one-time ($252.1 million), excluded from the net local revenues during 2008.

adopted by the government in 2009. Payroll expenditures were cut by 19.6%. As a result of these developments, the current deficit in the budget declined by 8.2% in 2009 compared to the previous year. This deficit accounts for 22.4% of the GDP (nominal), while the overall budget deficit excluding grants and aids has fallen by 7.5% in 2009 compared to past year. Taking grants and foreign aid into account, this deficit amounts to $ 144.4 million (or a rate of 2.5% of the GDP). This deficit was covered by the licensed banks (banking sector), compared to a surplus of 270 million dollars in 2008 (or a rate of 4.4% of the GDP). This is due to the significant reduction in the size of grants and foreign aid in 2009, as indicated earlier.

As to the Palestinian banking sector, the year 2009 saw many accomplishments at the level of the legal and regulatory framework governing the banking business, particularly with regard to the Banking Law, the new law for the Monetary Authority (Central Bank Law), and the regulation of licensing and controlling specialized lending.

In the context of the Monetary Authority's efforts to curb the phenomenon of bouncing checks for insufficient funds, and to strengthen the legal status of the checks as an instrument of payment, the Monetary Authority has been engaged since the beginning of 2009 on developing a new electronic system for bounced checks[2]. The system is based on automated entry of data in accordance with reports issued by the clearing-house at the Monetary Authority, without any intervention by banks. This system is characterized by the comprehensiveness, timeliness, and accuracy of the data, as well as by consolidating multi-account customers in more than one bank.

These developments and reviews of the legal and regulatory frameworks were intended to reinforce and consolidate the degree of financial and banking stability in order to ensure positive outcomes at the real economy level, in light of the strategic transformation plan adopted by the Monetary Authority in 2006, which aims at converting the Authority into a modern central bank with full powers. After three years of implementing the transformation plan, the Monetary Authority achieved a number of accomplishments

[2] This system was officially lunched at January 2010.

targeted in the plan, most notably the restructuring of the human capital, emphasizing its importance, and investing in it and in its management. The objective is to enable the human capital to effectively contribute to achieving the goals of the Monetary Authority, namely, the financial stability as a first stage, and the monetary and price stability at a later stage, when conditions are favorable.

The indicators of the banking sector achieved significant improvement in 2009, marking an increase in the net assets / liabilities of banks by 6.5%. Such improvement was due to the continued public confidence in the banking system. The main increase in the consolidated balance sheet of the banks was due to the growth of customer deposits by 7.7%, or by the amount of $ 449.7 million over the previous year. The ownership equity (net) also recorded a growth rate of 12.4% over the previous year, driven by the increase in the volume of paid-up capital of banks by 15.3% due to PMA instructions in 2009, which obligated banks to raise their capital to $ 50 million, as part of a plan to strengthen the banking system's ability to cope with any potential risks, especially in light of the deficiencies whose impact has hit most of the global banking systems as revealed by the global financial crisis.

The banks have also demonstrated a concrete trend to invest their funds in the local economy. The credit facilities granted during the year 2009 have increased by about 22.2% compared to the previous year, amounting to 2234.3 million dollars, the highest level since the inception of the banking operations. This has positively reflected on the ratio of facilities to customer deposits, which reached 35.5% compared with 31.3% last year. On the other hand, placements aboard have decreased by 3.3%, in light of the new PMA instructions aimed at reducing the ratio of placements aboard to the total deposits to 55%, which contributed to reducing this ratio from 56.2% in 2008 to 51.1% in 2009, a clear indication of the banks' responsiveness with the PMA plan to promote inward investment of their deposits.

The financial viability indicators of the banking sector have experienced an apparent improvement in 2009. And in a continuation of the phased plan to enhance the paid-up capital of the banks, the last instructions No. (7 / 2009) was issued in 2009 to regulate the paid-up capital. The instructions obligated all banks (national and foreign) to raise their paid-up capital to a minimum of $ 50 million. The increase should be implemented in two phases: first, to complete the payment of the paid up capital to $ 35 million by the end of 2009; and second, to complete the payment of capital to $ 50 million by the end of 2010. In addition, foreign banks are required to put (with the PMA) at least 21% of their capital (allocated to the branches in Palestine) as a non-withdrawable capital deposit, that should not fall below the amount of $ 10 million.

With the strengthening of capital in the banking sector, the sector's capability to accommodate the expected losses resulting from defaulting facilities was enhanced. The ratio of non-performing loans net of loans- loss provisions to capital have decreased from 4.4% in 2008 to 1.7% in 2009. This significant improvement in this ratio was reinforced, in addition to the capital, by the apparent decline in the volume of defaulted facilities in 2009. Such defaulted facilities have declined by 38% less than the previous year, to reach down to $ 92 million. As to the national banks' capital adequacy ratio, it has suffered a decline from 23.9% in 2008 to 21.9% in 2009. Nevertheless, this ratio remains good and higher than the 12% threshold required by PMA, and higher than the 8% threshold determined by Basel.

The banks have also achieved a significant improvement in terms of the quality of asset indicators. The ratio of non-performing loans to total gross loans declined significantly in 2009 to reach 4.1% compared with 8.1% in the previous year. As regards credit concentrations, it was noted that there was a relative stability in the volume of the facilities granted to the public sector, accounting for about 29% of the total facilities, whether in 2008 or in 2009. Its percentage of the ownership equity (net) is 62.5% and 66.5% in 2008 and 2009, respectively. This is a high percentage and indicates a considerable concentration that may have a negative impact on the banking stability in the event that the public sector falls under any financial or political crises, particularly in light of the instability of the finance sources for the public budget of the Palestinian Authority, which is heavily dependable on external aid to cover the budget deficit. As to the distribution of credit facilities to the borrowing economic sectors, the rates of credit granted to each sector have shown that there is no concentration of facilities granted to a particular sector. Such facilities are distributed in various ratios to these sectors; there are variations between the shares of these sectors in total facilities and the rates of the sectors' contribution to the GDP.

The improvement in the indicators of the consolidated balance sheet of banks has also reflected on the banks' profits. The net income of the licensed banks increased by $ 18.7 million in 2009, or 22.2% over the previous year, reaching up to $ 103.2 million, which has reflected on the profitability indicators. The ROAE (return on average equity) index increased from 14.9% in 2008 to 15% in 2009. The ROAA (return on average assets) index has improved by going up from 1.6% in 2008 to 1.8% in 2009. This is a good ratio and reflects an improvement in the efficiency of the banking sector in utilizing its assets. The net interest margin index has declined from 74.5% in 2008 to 65.4% in 2009, due to the decline in net interest income by $ 23.9 million dollars, or by 10.7% in 2009 compared to the previous year.

As for the liquidity indicators, the ratio of liquid assets to net assets index declined from 55.5% in 2008 to 50.9% in 2009. Despite the decline in the value of this indicator in 2009, liquid assets still constitute a good percentage of net assets in the banking sector, which indicates the ability of the banking sector to meet its obligations and to ensure that it is not vulnerable to financial crises such as lack of liquidity, which is one of the biggest risks to the banking sector.

It is worth mentioning that there is another type of liquidity crises which has faced the banking sector for the last two years. These are external risks resulting from the Israeli occupation authorities banning the inflow and outflow of cash in all currencies to and from the Gaza Strip. In addition, the Israeli banks refuse to receive the liquidity surplus of the shekel in both the West Bank and Gaza Strip. This type of external liquidity crises will have a great impact on the degree of banking and financial stability if it continues. The PMA is working hard through all possible ways and means to find alternative solutions to this crisis and to prevent the continuation of its negative impact on the banking stability.

With regard to the developments in other non financial institutions, which are subject to the oversight and regulation of the Palestinian Capital Market Authority (PCMA)[3], consisting of insurance companies, mortgage companies, leasing, and the Palestine Securities Exchange (PEX), the juvenility of PCMA with its regulatory and legal frameworks are incomplete yet and with the limited data available to it, has prevented the provision of a complete database on the activities of these companies, except the PSE data and some data on the insurance sector, which does allow for incorporation thereof in this report as required.

At the level of the Palestine Securities Exchange (PEX), the year 2009 witnessed a rise in the number of listed companies in this market up to 39 companies, compared to 37 companies by the end of 2008. As for financial brokerage firms, there was no change. Their number has settled at 10 companies, as was the case in 2008. Al-Quds General Index achieved a growth rate of about 11.6% to reach 493 points, compared to 441.7 points in 2008, mainly supported by higher indices of all sectors except the insurance sector. However, there has been a decrease in the number and value of shares traded. The number of traded shares increased by 29.5%, with a decrease in value by 57.8% compared to the previous year, despite the higher number of trading sessions by the end of 2009 up to 246 sessions, and by 0.8% over their number by the end of 2008.

In the insurance sector, the number of companies remained at 10 companies in 2009, without any change from the previous year. They provide services through a branch network of 88 branches. The aggregate assets of these companies increased by 7.1% to 299.3 million dollars in 2009 compared with 279.5 million in the previous year. Also, their paid-up capital increased by about 4.3% to more than $ 55 million by the end of

[3] Palestine Capital Market Authority was initiated in the second half of 2005 as an independent supervisory authority. Its objective is to provide a suitable environment for capital to grow and protect the funds of investors.

2009. With regard to other sectors (property mortgage, finance lease), no updated data was available to date (other than the data for 2007).

It should be noted that the all other financial non-banking institutions has a modest contribution to the Palestinian financial sector as a whole, when compared to the banking sector, which accounts for the largest share thereof.