

EXECUTIVE SUMMARY

ENCOURAGING MICROENTERPRISE IN ISRAEL VIA MICROCREDIT ORGANIZATIONS

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Recommendations:

- Amend Section 21 of the Banking Law in order to authorize the establishment of credit organizations to provide credit from sources in Israel other than banks.
- Facilitate the establishment and operation of credit unions in Israel. The success of credit unions worldwide demonstrates clearly advantages available to the Israeli economy.
- Credit unions can provide an effective solution to the inability of many microentrepreneurs and low income populations in Israel to secure credit on reasonable terms.
- Microenterprise organizations authorized to provide services and credit could over time generate more than 60,000 jobs and contribute more than NIS 3 Billion annually to the Israeli economy.

Introduction

Establishing microenterprises in Israel is not a simple or easy process.¹ Potential entrepreneurs find, in many cases, that access to bank credit is blocked or extremely restricted. In addition, they must cope with cumbersome bureaucracy and lengthy registration procedures that consume precious time and resources. Finally, once establishing a business, microentrepreneurs face the challenges of management, accounting, and taxation that usually are beyond the scope of their expertise and occupation.

The direct and indirect costs, the financing difficulties, and the shortage of information in Israel constitute significant obstacles to anyone wishing to establish an independent business, all the more so for anyone lacking resources or prior experience. Realization of the entrepreneurial potential among the weakest population groups therefore requires tools for financing, support, and guidance that will help microentrepreneurs in Israel along the way to a successful independent business.²

Encouraging Entrepreneurship within the Weakest Sectors

As of 2004, there were approximately 780,000 people in Israel in the prime working age groups (25-54) who were unemployed or outside the civilian workforce.³ A United States study that reviewed the basics of microenterprise found that the business entrepreneurship potential within such a population is approximately 8%.⁴ However, the support available for microenterprise in Israel is minimal relative to the demand within the potential target population.

Today, there is no single entity in Israel with a program capable of serving significant numbers that unites all the components of support for microenterprise. Potential entrepreneurs must seek different elements of support in various places. Ironically, coping with the support system can become an additional burden to entrepreneurs, rather than facilitating the process. Table 1 presents the current divided state of the microenterprise support system in Israel. Israel's potential microentrepreneurs cannot obtain the three components of support in order to open a business at a single location.

Table 1
Microenterprise Support Components Available in Israel

Support Component/ source	Assistance with bureaucratic procedures, registration, and information	Financing	Business-related Mentoring after Starting Business
Entrepreneurship Development Centers	Yes	No (referrals to funds)	Yes
Business mentoring project – Ministry of Industry, Trade, and Labor	No	No	Yes
Philanthropic funds	Some	Grants or financing through guarantees. Guarantee always required from the entrepreneur.	Some
Social Service-type Organizations	Partial	No	Partial

Source: Based on data from the Israel Small and Medium Enterprises Authority, <http://www.asakim.org.il/mokdim.php?pageid=0> (May 7, 2006); Ministry of Industry, Trade, and Labor, <http://www.moit.gov.il/NR/exeres/0962F037-4546-4F5F-873E-FA2B0591196E.htm> (May 8, 2006); Israel Small and Medium Enterprises Authority and Business Data Israel Ltd., *Financing Funds for Small Businesses* (January 2006), p. 25-40, <http://www.asakim.org.il/upload/kranot05.pdf> (May 7, 2006).

If every person wishing to open a micro business had a real opportunity to receive assistance, financing, and business guidance, **approximately 62,400 businesses could join the Israeli economy – each creating at least one employment position.**⁵ Assuming the monthly turnover of each microenterprise is equivalent to minimum wage plus value-added tax (about

NIS 4,000), **the added business activity of these enterprises (and the related businesses) would lead to an increase in Israel's GDP by some NIS 3 billion.**⁶ The improvement in the economic condition of those engaging in microenterprise would also be reflected in reduced payouts of income-dependent allowances, increased workforce participation, and improved welfare for the poorest members of society.

No single organization in Israel with a program capable of serving significant numbers of microentrepreneurs unites all components of support needed in contrast to specialized organizations that fulfill the need for these services in most countries.

Microcredit Organizations

Microcredit organizations offer credit, loans, and other financial services (deposits, insurance, and savings) to the poorer segments of the population.⁷ This activity attempts to fill the gap between the high threshold requirements for credit in the traditional banking system (assets, guarantors, regular income, credit history), and the need for credit for financial and personal development in populations that cannot meet these requirements. In addition, many microcredit organizations provide active assistance to microenterprises through support services above and beyond credit. Microcredit organizations may operate in various ways, under a variety of legal registration formats: as commercial banks, designated microcredit banks, cooperatives, credit unions, NGOs, or other financial institutions.

Micro Credit Organizations Worldwide

United States

There are 517 non-bank credit organizations in the US established for the purpose of providing loans, instruction, and technical assistance, with a focus on microentrepreneurs. The microcredit sector in the US has existed for some twenty years, and is now spread throughout all fifty states. The organizations' activity focuses on creating jobs for low-income earners: according to a survey performed by the Association for Enterprise Opportunity (AEO) among US microcredit organizations in 2005, 77% of participant organizations responded that over 50% of their customers had low income levels.⁸

A survey conducted from 1991 to 1997 found that 53% of participants in microcredit and business entrepreneurship programs who had been classified as poor, emerged from poverty. Furthermore, there was a 30% decline in the number of persons in need of income-dependent government allowances.⁹

Western Europe

There are dozens of microcredit organizations in Western Europe. Most of these organizations are now in the process of adapting their services to their customers, after having attempted to duplicate activity patterns from other countries. The minimum loan amounts granted through these organizations range from 50 to 5,000 euros, while the average loan is 12,000 euros. Like their US counterparts, European microcredit organizations provide a range of services to entrepreneurs beyond the financing itself: marketing, sales, cash flow management, accounting, correct pricing, assistance with legal issues, taxation, writing business plans, setting objectives, assistance with time management, household management, and customer relations.¹⁰

In light of the potential inherent in microenterprise and the absence of tools for the encouragement of this sector in Israel, we will now examine the factors that have prevented microcredit organizations such as those described above from operating and developing in Israel.

Barriers to the Development of Microcredit Organizations in Israel

Regulation and Legislation

In Israel, a microcredit organization interested in operating as a banking corporation would be required to comply with the threshold requirements stipulated in the Banking (Licensing) Law, 5741-1981. The Governor of the Bank of Israel, in collaboration with a licensing committee comprised of Bank members, discusses applications for banking licenses and determines their approval or rejection. In recent years, however, it has been the Bank of Israel's explicit policy to reduce the number of small banks in Israel and to encourage a consolidation process, resulting in the formation of several large banking groups.¹¹ This policy reduces the likelihood that a banking license would be granted to an entity planning to engage in microcredit.

At the same time, Section 21 of the Banking (Licensing) Law prohibits both receiving monetary deposits from and granting credit to over 30 people, without a banking license. This prohibition precludes the potential operation of credit unions in Israel. Furthermore, the aforementioned Section 21 restricts the possibility for credit granting by auxiliary banking corporations (which are controlled by a bank but do not hold a banking license in their own right), and prevents the financing of credit by issuing securities (equity), for anyone without a banking license.

A legal infrastructure allowing lending by non-banking organizations seemingly exists in Israel. The Non-Bank Loans Arrangement Law, 5753-1993, clarifies the obligations and rights of both parties to a "gray market" loan: preparation of a written contract, disclosure requirements regarding the cost of the loan and the real interest demanded for it, and a restriction of the maximum cost of the credit.¹² However, the law does not provide a comprehensive legal solution for non-bank credit activity. Issues related to the foreclosure of guarantees by the lender, debt issuance, capital raising, and the option of using collateral are only a few of the subjects not regulated. Thus a microcredit organization seeking to operate in Israel will encounter an inadequate legal infrastructure for its activity, which requires it to operate at a greater level of risk to its assets.

Financing

Like any business, organizations that wish to provide credit to microenterprises need the initial capital to begin operations. Ironically, a microcredit organization applying to banks for financing suffers the same problems confronting its future customers. Banks will find it difficult to finance the initial stages of a credit organization using methods foreign to them, without a history of success, planning to serve a population which they themselves are unwilling to serve or which they perceive as weak.¹³ It is thus no surprise that organizations that work to provide assistance by granting loans in Israel do so through philanthropic capital and grants which they receive for that purpose.

Commercial activity, even if carried out by non-profit organizations, allows the creation

of the conditions for preservation of the initial capital. Commercial activity also includes raising capital, in order to expand operations and attain self-sustainability. Global experience demonstrates that the leading microcredit organizations, in terms of market penetration, loan amounts, variety of services, and efficiency, are those that operate commercially and attain a sustainable level of coverage of their operating and financial expenses.¹⁴

Removal of Regulatory Barriers and Financing, Based on International Experience

The most direct way to permit the legal operation of microcredit organizations would involve specific legislation targeted to these organizations. Microcredit laws have been passed mainly in Eastern European and Central Asian countries. The key reason for this is the relatively widespread operation of microcredit organizations in these areas, and the suitability of the microcredit tool to the economic characteristics of countries in the region. In recent years, laws regulating microcredit have been passed in Bosnia-Herzegovina, Kyrgyzstan, Kazakhstan, and other countries in Eastern Europe and Central Asia.

Aside from specific laws, changes in regulation can contribute to the development of microcredit organizations. An example of regulatory facilitation for microcredit organizations comes from France, where the legal infrastructure does not allow lending without a banking license. Nonetheless, the French supervisor of banks (Comité de la Réglementation Bancaire) has allowed the microcredit organization ADIE to grant credit and finance it through debt issuance (bonds), despite the fact that it is not a bank.¹⁵ In Israel, lending and financing through bond issuance are not possible for institutions other than banks.

Microcredit activity can also be encouraged by permitting the operation of credit unions. Credit unions are financial cooperatives owned and controlled by their members. Although not a total solution for microenterprises, these membership organizations offer savings and loan services under preferred conditions, and facilitate lending to entrepreneurs with few or no assets. Each credit union is based on common characteristics that determine who is eligible to join. The common characteristic can be a geographical region, an employer, or membership in a particular organization (a church, professional association, guild, and so forth). Around the world, there are comprehensive laws that enable and regulate the operation of such organizations. In fact, credit unions have operated in the US since 1909. Today they serve close to 85 million people, with assets totaling approximately \$755 billion. In England, a credit union law was passed in 1979, and today the UK has 564 such organizations.

Financing the Activity of Microcredit Organizations

Even after the operation of microcredit organizations becomes possible and they are permitted to operate in a manner that allows financial sustainability, the credit organizations normally do not have a sufficient record of accomplishment to obtain commercial banking capital. For this purpose, financial tools have been developed abroad to bridge the lending gap between banks and microcredit organizations.

One of these tools is capital funds for microcredit. The funds work to build a commercial relationship between microcredit organizations and established financial institutions – primarily banks – in order to finance operations and allow a transition from reliance on philanthropic capital to commercial capital. A key method of operation in this context is the provision of medium and long-term loans at low interest rates to microcredit organizations.

Loan amounts from the capital funds are used to leverage loans from local commercial banks. This results in the formation of substantial capital for microcredit activity, as well as enabling the credit organizations to establish credit histories with banks.

Capital funds for the development of microcredit organizations can originate within commercial organizations, such as the Deutsche Bank MicroCredit Development Fund, from government programs to encourage this type of activity, such as the US Treasury Department's CDFI (Community Development Financial Institutions Fund) or through a government policy of encouraging the private financial markets to fund these initiatives, such as the Community Reinvestment Act.¹⁶

Another financial tool aimed at boosting credit organization activity is guarantees. Guarantee funds for microcredit organizations facilitate access to commercial bank financing for credit organizations. For example, the Latin America Bridge Fund of the ACCION organization was the first fund to provide guarantees on behalf of microcredit organizations. The fund was founded in 1984, and since its inception, it has provided guarantees for loans from local commercial banks for \$70 million, to 23 microcredit organizations in South America and in the Caribbean Islands. The loans granted with the aid of the fund's guarantees have helped provide some \$140 million in microcredit to 300,000 entrepreneurs to date.¹⁷

Conclusion and Recommendations

The importance of nurturing Israel's human capital does not require explanation.. Microenterprise is one important means for maximizing individual human capital and improving the financial condition of the weakest members of society. Encouraging entrepreneurship enables individuals to help themselves fulfill their potential and contribute to Israel's economic expansion.

1. Examine banking legislation in Israel. If the banks themselves are unable or unwilling to supply financial services to weak population groups, other organizations should be allowed to do so. The primary changes needed are to amend the provisions of the Banking (Licensing) Law, 5741-1981, particularly Section 21 of the law, which restricts all non-bank credit activity.
2. Expand legislation that regulates non-banking financial activity. The Non-bank Loans Arrangement Law, created in response to the exploitation of borrowers on the "gray market," is insufficient. Lending as a commercial business activity should be backed by a legal infrastructure. This infrastructure should stipulate, among other things, reporting requirements, management, regulation of the ability to raise capital under different forms of ownership, regulation of activity in case of bankruptcy, and regulation of debt collection in case of debts in arrears.
3. Allow credit unions to operate in Israel. These entities can serve as a convenient solution to the credit shortage suffered by many microentrepreneurs and weak population groups, as well as stimulate competition in the financial markets. The success of credit unions worldwide demonstrates the extent to which they are needed in Israel. Beyond their impact as credit providers for entrepreneurs, credit unions have stimulated competition by providing varied services that were previously the exclusive domain of the banks.

Based on global experience the implementation of these measures can constitute an important step towards improving the range of financial services offered in Israel, primarily access to credit to those unable to secure financing on reasonable terms, if at all. Microenterprise would enable more people to realize their entrepreneurial potential, create new businesses, and advance Israeli economic and social prosperity.

- ¹ For the purposes of this paper, a “microenterprise” is equivalent to the definition of an “Exempt Dealer” – a business operator or a business, whose turnover does not exceed the amount determined by the Finance Minister (currently NIS 65,721 per year). An “Exempt Dealer” is not required to pay VAT.
- ² Glenn Yago and Betsy Zeidman, *Building Israel's Small Business and Microenterprise Sector: Israel Entrepreneurial Finance Initiative* (Milken Institute, 2005), pp. 28-39.
- ³ Central Bureau of Statistics, *Statistical Abstract of Israel 2005* (Jerusalem: Central Bureau of Statistics, 2005), Table 12.1.
- ⁴ See: Elaine Edgcomb, Klein Joyce and Peggy Clark, *The Practice of Microenterprise in the U.S.: Strategies, Costs and Effectiveness* (Washington, D.C.: The Aspen Institute/FIELD, 1996).
- ⁵ This calculation was performed based on 8% who would fulfill the microenterprise potential, out of approximately 780,000 persons unemployed or outside the civilian workforce in Israel.
- ⁶ As of May 2006, minimum wage is NIS 3,456. Adding 16.5% VAT gives NIS 4,026. To obtain the annual turnover of the business, this amount is multiplied by 12, which is NIS 48,312. Assuming that 62,400 microenterprises are created, with an average annual turnover of approximately NIS 48,000, the direct added product totals NIS 2.99 billion.
- ⁷ Also to be known as microfinance institutions or MFIs
- ⁸ <http://www.microenterpriseworks.org/services/research/2005Directory.htm> (March 8, 2006).
- ⁹ See: The Aspen Institute, Economic Opportunities Program, *Microenterprise Assistance: What Are We Learning About Results? Key Findings from the Aspen Institute's Self-Employment Learning Project* (Washington D.C.: The Aspen Institute, 1997);
<http://www.microenterpriseworks.org/about/factsheets/factsheet1.pdf> (June 12, 2006).
- ¹⁰ European Microfinance Network, *Overview of the Microfinance Sector in Western Europe* <http://www.european-microfinance.org/bibliotheque/232.pdf> (March 8, 2006).
- ¹¹ <http://www.bankisrael.gov.il/press/eng/050711/050711c.htm> (25 June 2006)
- ¹² Non-bank Loans Arrangement Law, 5753-1993, Section 753 (Aug. 3, 1993), p. 174.
- ¹³ See: Rosalind Copisarow, “The Application of Microcredit Technology to the UK: Key Commercial and Policy Issues,” *Journal of Microfinance* Vol. 2, No. 1 (2000).
http://marriottschool.byu.edu/microfinance/view_archive.cfm?id=28&issue=spring00 (June 12, 2006).
- ¹⁴ Isabel Barres, “Bulletin Highlights,” *Microbanking Bulletin* 8 (November 2002), pp. 25-29
http://www.mixmbb.org/en/mbb_issues/08/Bulletin%20Highlights.pdf (June 12, 2006).
- ¹⁵ Jan Evers, Stefanie Jack, Adrian Loeff and Hedwig Siewertsen, *Reducing Cost and Managing Risk in Lending to Micro Enterprises* (FACET, Zeist, The Netherlands and IFF, Hamburg, Germany, 2000), pp. 58-66, http://www.microfinancegateway.org/files/3243_3243.pdf (May 22, 2006).
- ¹⁶ Aharon Mohliver and Eyal Seri, *Credit Discrimination in Israel: A Proposal for Reform*, Policy Research 2005-4 (Jerusalem: KIEDF Israel, 2005)

- ¹⁷ Cesar Lopez and Jorge de Angulo, “Bridging the Finance Gap: ACCION’s Experience with Guarantee Funds for Microfinance Institutions,” *InSight* 15 (September 2005). <http://www.accion.org/insight/> (April 22, 2006).

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