

Support to the transformation of UNRWA MD into a microfinance bank

UNRWA MD, Occupied Palestinian Territories, Jordan

1. Development relevance

UNRWA MD operates in West Bank, Gaza, Jordan and Syria. The microfinance industry in these areas has long been a donor subsidized industry evolving in a non-regulated environment with important political risks (Israeli-Palestinian conflict that regularly affects the MD activities in Gaza and / or the West Bank, Syrian crisis). But the market is evolving, with new donor policies pushing the institutions towards commercialization and sustainability and a suitable legal and regulatory framework has emerged.

UNRWA-MD is in the region the most prominent pro-poor microfinance initiative. Its transformation process targeted to unleash its potential for more outreach, hindered before by its incapacity to mobilize equity and refinancing credit lines. Furthermore, its transformation into a sustainable institution would have an important impact on a microfinance sector still largely donor dependent in the region.

Population and Economic indicators (West Bank and Gaza)	
Population (year)	4 169 506 (2013)
GDP growth (average: years)	13,8% (2012)
Inflation (average: years)	2,8% (2009)
Trade balance (% of GDP) (year)	18,8% (2012)
Foreign Direct Investment (net) (% of GDP) (year)	1,8% (2012)
Net ODA & official aid received (% of GDP) (year)	19,5% (2012)
Workers' remittances (% of GDP) (year)	na
Economic Freedom Index (Rank among 185 countries)	na
Poverty indicators	
GDP per capita (current USD) (year)	2530 (2012)
Gini Index (0= equality 100= inequality) (year)	35,5 (2009)
Multidimensional Poverty Index (1=poor 0=not poor) (year)	1,4%-98,6% (2007)
International (at 1,25 USD/day), national and rural poverty headcount ratio (year)	

2. Intervention approach and additionality

The overall aim of the project was to support the preparation of the transformation of UNRWA MD into an independent financial institution operating in the OPT, Jordan and Syria.

The inception phase started late in October 2013 due to the difficulty to find a period for the first mission that could fit with UNRWA MD constraints. The whole process was also delayed by a strike UNRWA (not only MD) staff from December 2013 to February 2014. This time has been used for intensive work on the underlying documents. Several versions of a strategy document as well as a work plan and a budget have been circulated between FIDES team and UNRWA MD and UNRWA Legal department. The last version has been finalized mid-December 2014 and have been presented to the UNRWA Advisory Committee.

In September 2013, FIDES mobilized its team and started the preparations through a planning exercise among the team members as well as UNRWA-MD team to kick-start the project. Team sessions took place to agree on next steps to finalize the work plan and agenda items specially the list of meetings to be conducted in West Bank and Jerusalem, in order to make the mission period as efficient and effective as possible.

The first mission on the ground in October 2014 allowed to implement the following steps:

- The FIDES team and UNRWA-MD management organized several working meetings to: (i) discuss and reach consensus and common understanding on the TOR and the underlying principles of the spin-off (transformation) strategy and work plan; (ii) secure the UNRWA commitment to the spin-off process.
- FIDES team worked with a team of leading UNRWA-MD staff that included the director, the operations officer, the head of West Bank's branches, the HR officer in charge of MD, and the internal auditor to:
 - o Introduce the project and to understand and to discuss staff concerns about the spin-off process, results, etc., and to decide on measures enabling informed consent of the team, that strengthen the buy-in of leading staff members for the transformation process.
 - o Review the corporate governance and management.
 - o Evaluate the requirements for institution strengthening and upgrade of internal processes, products and delivery mechanisms.
 - o Evaluate the requirements for capacity building / to identify precisely the capacity building needs/expectations of UNRWA MD (who will be trained, on what etc.).
 - o Discuss the legal, institutional and operational elements of the spin-off requirements.
 - o Discuss UNRWA priorities, preferences and also restrictions.
 - o Discuss the road map and agree on next steps
 - o Identify in an early stage potential threats to the process and measures to mitigate them.
- In order to update on new elements of the regulatory framework, and to understand the legal requirements of the spin-off (in particular the transfer of assets, liabilities and equity), FIDES team met with local lawyers to discuss these aspects of the process in-depth. The discussion also covered the different available legal alternatives and the structure of the future new company/ies. As a result of the discussions, FIDES produced the TOR defining the legal advisor's study and analysis on the feasibility of the transformation process in the different jurisdictions involved.
- The team met with Palestinian Monetary Authority to confirm their support to the project.
- The team met with Véronique Hulmann, head of SDC office in Jerusalem and briefed her on the project objectives and progress.
- During this meeting both of FIDES and UNRWA MD teams agreed on a road map and on a work and time plan. Both teams agreed on the division of tasks among FIDES and UNRWA MD. The teams agreed on a list of deliverables as mentioned under the forth section of mission outputs.

Important follow up activities included an exchange process with UNRWA legal department on a number of concerns that had been expressed by the lawyers of UNRWA.

A second mission was organized in December 2013. The experts had a one-day meeting with UNRWA legal department to review all comments provided and to come to a common understanding on the expected document.

Following the mission, FIDES team has drafted the ToR of a Palestinian lawyer to be hired by UNRWA to review the proposal and to investigate remaining legal issues.

A third mission was organized in April 2014 and continued to elaborate a set of the technical aspects of the transformation process with the UNRWA MD team. The strategy document was presented to the Microfinance Advisory Board meeting as planned on the 30.04.2014.

The Fides team and the Palestinian lawyer prepared respective PowerPoint presentations.

In June 2014 FIDES and UNRWA MD presented the approach and the proposed action plan to key UNRWA decision makers in a seminar organized in Amman. The team could achieve broad adhesion to the proposal.

FIDES then continued to sustain internal processes in UNRWA and helped UNRWA MD to mobilize interest for the transformation from donors and investors.

3. Results achieved

In an intense partnership with UNRWA-MD management a strategy for the spin-off of the MD and the creation of a regional microfinance bank with subsidiaries in three countries has been elaborated. It has been validated by lawyers and finally endorsed by UNRWA management:

- I. The recommendations to the Commissioner General elaborated by the MD-Advisory Board meeting held on the 21.11.2013 have been formally endorsed on the 26.03.2014.
- II. A revised version of the strategy document has been prepared. It included the results of the discussions with the UNRWA MD department. The work plan has also been revised.
- III. In addition, it was clearly identified that the transformation project would require much more funds and human resources than initially planned. This was the reason why exchanges between UNRWA MD, FIDES AG and SDC have taken place. They have led to an expression of interest of SDC to provide support to the transformation process and to the creation of a foundation/holding structure in Switzerland. Based on these discussions, Fides AG has drafted a concept note and a budget that have been submitted to SDC. Funding by SDC via a new UNCDF project has been considered and a project associating UNCDF as executing partner has been elaborated.
- IV. The new Commissioner General confirmed the approval of the final version of the Strategy document (see Attachment I). This document elaborated under SCBF support has thus been adopted as the reference to guide the transformation process.
- V. A budget for the Spin-Off project has been set up and submitted to SDC.
- VI. In addition, the BoD has decided to set several committees (legal issues, human resources, etc.) to take care of particular aspects of the transformation process.

4. Lessons learnt and further challenges

The key steps of the project have been successfully achieved even if the whole process has been much more complex and than initially envisaged. Key challenges linked to the institutional structure of UNRWA have been overcome.

The highest level of management of UNRWA MD has endorsed the spin-off and has defined the strategy document prepared under this SCBF funding as the baseline for the process. In that sense the project has fully delivered what was required and has achieved its objectives.

Apart from unforeseen events (strike), it has also appeared that decision making processes inside UNRWA were complex and involved a lot parties that did not always share the same vision. If the transformation itself was clearly a necessity for the head of the the UNRWA MD team, this was less clear for some other UNRWA stakeholders who did not see any interest to allow one of the most successful projects to become independent.

Attachment 1

STRATEGY AND BASIC ACTION PLAN ON SPIN-OFF OF UNRWA'S MICROFINANCE PROGRAMME

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- Spin-off and Transformation Budget
- Basic Work & Time Plan Chart

1. Acronyms:

Board:	Board of Directors
DCG:	Deputy Commissioner General
DLA:	Department of Legal Affairs
ESOP:	Employee stock ownership plan
FIDES:	Financial Systems Development Services AG, Fribourg/Switzerland
HR:	Humane resources
MD:	Microfinance Department
MENA:	Middle East and North Africa
MFI:	Microfinance institution
MoU:	Memorandum of Understanding
MTM:	Management Team Meeting
NGO:	Non-government organization
PMA:	Palestine Monetary Authority
PR:	Public Relations
Reg. MFI:	Regional microfinance institution
SCBF:	Swiss Capacity Building Facility
SDC:	Swiss Development Corporation
SOP:	Standard Operating Procedures
TA:	Technical Assistance
UN:	United Nations
UNBOA:	United Nations Board of Auditors
UNGA:	United Nations General Assembly
UNRWA:	United Nations Relief and Works Agency for Palestine Refugees
USD:	United States Dollars

STRATEGY NOTE AND BASIC ACTION PLAN

SPIN-OFF OF UNRWA'S MICROFINANCE PROGRAMME

Purpose: This paper is intended to explore institutional alternatives for spinning off UNRWA's Microfinance Department (MD) and proposes a way forward to establish it as an independent legal entity to preserve and expand the UNRWA mission. The paper starts with the rationale of the envisaged transformation and a summarizing overview of the multiple efforts carried out since 2005 to analyse, justify and plan the envisaged spin-off. The paper then proposes and discusses alternative institutional options for the spin-off in adherence with UNRWA's relevant regulations and guided by UNRWA's overall mission and commitment towards Palestinian refugees. The paper concludes with a basic action plan which outlines the principle phases of the spin-off starting with a legal research on the most suitable institutional structure, the planning and execution of the selected structure, the transfer of staff and assets including the loan portfolio and IT systems up to the commencement of operations.

A. Background

1. **Rationale:** Over the past 20 years UNRWA's microfinance programme has invested USD 358 million in 318,255 loans. In 2011, the programme financed 40,000 loans valued at USD 44.5 million from its loan capital of USD 23.30 million and a USD 10 million trust fund. The programme, which began in Gaza in 1991 as small project with a capital of less than USD 300,000 and just eight staff, has grown to become a substantial, best practice microfinance operation with annual expenditures of USD 8.17 million. Headquartered in Jerusalem, with a staff of over 400 working in 21 branches and four regional offices located in the West Bank, Gaza, Jordan and Syria, the programme is run on a profit basis and covers its annual costs from its credit operations.

UNRWA's microfinance programme is among the largest and most extensive microfinance operations in the Eastern Mediterranean area of the Middle East, and – in the case of Palestine – for the past four years it has accounted for 10-13 per cent of all new credit facilities recorded in the Palestinian national credit bureau each month, which includes 18 commercial banks and two other microfinance institutions.

Given its current scale of operations and profitability, **the time is ripe for it to transform from the UNRWA microfinance programme into a separate and independent microfinance organization.** There are essentially three business reasons for transformation:¹

¹ From: "Microfinance Spin-Off and Transformation" presented at Advisory Board meeting, 21 Nov. 2013.

a. **TO GAIN ACCESS TO CAPITAL AND EQUITY:**

- i. **The UNRWA programme has not consistently been able to meet its business objectives and plans** due to its restricted ability to raise the finance required for the programme to achieve its planned outreach and product diversification, e.g. housing microfinance, which meant that it has consistently underperformed in terms of its implementation plans;
- ii. As a licensed MFI that is properly regulated and supervised, the new entity **would no longer be dependent on scarce and insecure donor grants** for its financing needs but would be able to raise capital from IFI, banks and specialized MIVs to meet its business planning needs and growth projections;
- iii. **It would also be able to secure its sustainability and grow** through equity, technical assistance and capacity building finance from financial institutions taking a stake in the new entity, which would bring additional finance, risk and operational management experience to the new entity and its board of directors.
- iv. On the social impact side, new capitalization and equity will enable the new entity **to serve more clients, with a more diverse range of products than it is able to do now**, and while the Palestine refugee share of clients may decline relatively the number of Palestine refugee clients are expected to grow absolutely, especially as the majority of the new entity's staff will continue to be Palestine refugees and former UNRWA staff.

b. **TO OPERATE IN A SUITABLE INSTITUTIONAL, GOVERNANCE AND CORPORATE STRUCTURE:**

- i. **UNRWA's interest rates are significantly higher than other MFIs** because of the higher administrative and transaction costs of delivering credit through a UN organisation;
- ii. Running a comparatively sizeable self-sufficient microfinance operation **as going concern within the compass of UNRWA's generic and bureaucratic procedures**, together with the Agency's limited governance framework and narrow corporate management culture, presents continuous and serious challenges to the effective, efficient and long term management of the programme;
- iii. **Rational business decisions are frequently overturned** by political expediency, low prioritisation or competing interests that would not occur in a normal microfinance organisational environment;
- iv. **UNRWA's DLA has had long-term concerns over the programme operating in national business environments** on the basis of commercial law and enforceable legal contracts. It considers the risks to be a significant and incompatible with safeguarding UNRWA's immunities and privileges. This has been a long-time source of contention between both departments (see DLA's two papers outlining its views on transformation).
- v. **The Palestine Monetary Authority (PMA) is pressing UNRWA to apply to be licensed to be part of** the regulated and supervised microfinance sector just as **all other microfinance organizations** have come under the PMA umbrella. The PMA is prepared to enter into a MOU with UNRWA, but is requesting that UNRWA provide a timeline for transformation, after which the transformed programme would be licensed and part of the regulated microfinance sector in Palestine.
- vi. **PMA pressure on the UNRWA programme to transform would also be beneficial to the programme itself.** A properly regulated and supervised financial institution gains higher confidence of its customers and – equally important – enjoys an enhanced access to funding due to improved creditworthiness.

c. TO PROVIDE ADDITIONAL FINANCIAL SERVICES:

- i. As a licensed and regulated finance institution the new entity would be able to provide a **broader range of services to many more Palestine refugees and other clients** than it can as an unregulated and unlicensed UN agency;
- ii. Foremost among this would be **the ability to provide safe-saving services**, which would enable the programme to open up its services to many more poor people. Micro-savings have a much greater potential to reach the poorest clients, most of them unbanked, than can be achieved with microcredit and would substantially improve the outreach of the programme to the most marginal communities across the region;
- iii. Additionally, **regulated savings services would provide a source of capital** that the new entity could use to provide loans and lessen dependency even on financial credit;
- iv. The new entity can already be licensed as a social finance institution (or microfinance bank) in Syria today, but most interesting is the **PMA plan to open saving services to licensed and regulated Palestinian microfinance institutions** within the next two years and has already identified UNRWA as one of the two institutions ready for such incorporation;
- v. Like other MFIs in the region, the new entity would be able **to pilot insurance services**.

In conclusion a transformation of the UNRWA programme into a separate legal and regulated entity **will enhance the long-term sustainability of the programme and preserve its mission** “to provide income generating and asset building opportunities to Palestine refugees and other proximate poor and marginal groups”. The transformation will **enable the Programme to grow and offer more inclusive finance services** to an even larger number of its target group across the region than it is able to provide now. As a separate legal entity, the Microfinance Programme will be able **to break its dependency on insecure donor grants** by mobilizing shareholder equity, client deposits and accessing domestic and international capital markets. It will upgrade its institution and capacity building through **new corporate management and appropriate governance** by its own Board and subject to the respective regulatory environment of its target countries.

2. **Recap on Spin-Off Considerations²**: UNRWA has been engaged in planning for spin-off and transformation since 2004, with transformation being a key topic in board meetings since 2005. With the support of key donors, UNRWA has since then spent USD 731,700 on planning and preparation for transformation. This rises to over USD 1.50 million if investments in the new microfinance banking software were included.

The MD has taken numerous concrete steps to invigorate and move the transformation process forward: **(i)** It developed a broad range of credit products that enabled the programme to become profitable and serve a wide range of poor and low-income clients; **(ii)** In 2009 it joined the Palestine National Credit Bureau together with 18 commercial banks and three NGOs, where it continues to account for between 11 to 14 per cent of all new credit facilities opened each month, although accounting for less than 2 per cent of the value of credit issued. **(iii)** In 2010 the MD purchased a new on-line microfinance banking software that includes general ledger, credit and savings modules to facilitate a smooth transformation process and to meet the regulatory requirements of central banks. The system has now been rolled out in West Bank and Jordan and is in the process of being rolled out in Gaza to be followed by Syria early next year; **(iv)** The MD also

² From: “Microfinance Spin-Off and Transformation” presented at Advisory Board meeting, 21 Nov. 2013.

commissioned various studies and engaged in numerous discussions for the spin-off, including in particular:

- a. 2007: **Banyan Global conducted a savings study** to determine the market for savings and help the department prepare to introduce savings products for low-income households, including a series of targeted saving products for education, health, marriage and asset building;
- b. 2007: **Quality Finance International completed a transition scoping study** outlining the key work that needed to be undertaken to proceed with the transformation process;
- c. In 2009: **Shore Bank International produced a feasibility study and transformation plan** with a model structure for transition to a holding company with three separate companies in Palestine, Jordan and Syria;
- d. 2010: **PWC-Luxembourg presented a prospectus on establishing a Foundation** to achieve transformation in a jurisdiction that would be acceptable to institutional investors;
- e. 2011: Preparation of **discussion and briefing notes for Com-Gen meetings** with host government officials;
- f. 2013: Financed by the public/private initiative of the Swiss Capacity Building Facility (SCBF) **FIDES is updating the transformation plan, legal assessment and initial valuation of UNRWA assets** (on-going project).

UNRWA has been engaged in planning for spin-off and transformation since 2004. Finally, on October 2013 the Deputy Commissioner-General communicated to the MTM that the Commissioner-General had decided that UNRWA should move forward with the transformation of the microfinance programme.

B. Lessons Learnt and Guiding Principles

3. **Principle lessons learnt from Previous Transformation**³ : Institutional transformations in the microfinance industry typically involve upgrading an NGO (or even merging several NGOs) to a formal non-bank finance institution or to a commercial bank; or upgrading a non-bank finance institution to a commercial bank. The first transformation of such kind took place in 1992 in Bolivia (when the NGO PRODEM was transformed into Banco Sol) and since then probably over a hundred other transformations followed worldwide. So far just a few transformations have been recorded as a failure⁴. Though

³ The term “transformation” is a generically used term in the microfinance world, which implies merely a change of the legal status of a microfinance entity. This is misleading. Only in very rare cases was a microfinance NGO transformed by simply having its legal status upgraded to a licensed limited liability company. Transformations typically take place through an asset transfer (occasionally also asset and liability transfer) from a microfinance NGO to a company established or purchased for this purpose. Subject to regulatory conditions the transferring NGO receives shares in return for its in-kind and/or cash contribution.

⁴ In Nicaragua and Zambia brought about through lack of governance and poor management.

each transformation has its own features and circumstances, the following principle prerequisites should be met for securing the success of any transformation:

- i. The entity to be transformed should **already be operating profitably**. Transforming a structurally loss making microfinance entity will hardly turn it profitable;
- ii. The entity to be transformed should **already enjoy good governance and a sound management** focused on transparency, efficiency and financial self-sufficiency;
- iii. **The relevant stakeholders** of the entity (sponsors, board of directors, management) to be transformed are required **to give their full backing and active support** to the transformation. A half-hearted attempt to transform is a useless effort;
- iv. **Motivated and properly prepared staff** is crucial for an effective transformation. This is particularly relevant, when an initially philanthropic microfinance entity turns commercial;
- v. **The operating environment should be encouraging**, i.e. offering significant growth and profit potential in order to make the transformation worthwhile. The transformation should offer a viable chances to improve the entity's market position and financial strength to the benefit of its clients;
- vi. **The regulatory environment should be conducive** to the transformation.

We consider that the UNRWA programme in general complies favourably with these conditions (with the Syrian component being a special case). UNRWA has meanwhile also confirmed its support through the DCG. The regulatory/legal conduciveness is still subject to a legal analysis.

4. **Uniqueness of the UNRWA Spin-Off:** Whilst the international microfinance industry has experienced numerous transformations around the globe, the envisaged transformation of UNRWA's microfinance programme will be unique and challenging in view of three aspects:

- I. Previous transformations typically involved upgrading an NGO to a formal microfinance institution or bank. **Here the transformation will take place through a spin-off from a multi-programme UN organization;**
- II. This will be the **first transformation ever of a microfinance programme run by a UN** organization. There are no models of transformation by sister UN organisations that UNRWA could replicate. The transformation restrictions faced by UNRWA are outlined below;
- III. **This will be the first transformation of a multi-country microfinance programme.** All transformations so far have been on national level only. Those who today are regionally active started their expansion to neighbouring countries only after completing their initial transformation. Transformation success stories such as ACLEDA/ Cambodia, XAC/Mongolia, Banco Sol/Bolivia underline this sequence of development.⁵

Conversely, the UNRWA microfinance programme is already operating in three separate jurisdictions, each characterized by its own regulatory and operating environment. Thus,

⁵ The social enterprise "Pro Mujer" is regionally active in Latin America, but has not transformed to date.

the envisaged UNRWA spin-off comes at a comparatively late stage. The challenge will be to re-establish the UNRWA microfinance programme as an independent legal entity, which caters for all three jurisdictions and paves the way for further expansion in terms of loan portfolio development, range of other financial services and regional outreach. The legal implications of the spin-off including the choice of jurisdiction and the corporate structure of the new entity will be subject to thorough legal research to be conducted by a Palestinian law office and its international associates.

5. **Guiding Principles for the UNRWA Programme Spin-Off:** Any legal, institutional, operational or commercial solution to be selected for extracting the UNRWA programme and establishing it as an independent legal entity will be guided by following strategic principles:

- I. **Preservation of Social Mission:** The new entity will remain committed to serving Palestine refugees and other proximate poor and marginal groups through the provision of financial services that reduce poverty and economically empower women and youth;
- II. **More Services to more Palestine Refugees:** The new entity will broaden its range of financial services in particular to Palestine refugees to cater for the financial demand as inclusive as possible. The new entity will endeavour to serve as “house bank” for its clients;
- III. **Sustainability:** The new entity will be structured, organized, funded and operated in a manner, that secures it as a going concern and allows it to grow thereby reaching out to an increasing number of its target group;
- IV. **Job Security:** Human resources constitute the most critical and sensitive aspect of a transformation. This relates in particular to the MD staff, who will be requested to depart from the UN organization and be employed by a private commercial entity. It is planned to keep all MD staff, either through transfer to the new entity or on a voluntary and competitive basis to other vacant posts within UNRWA. Continuation of employment in the new entity will be subject to performance and local labour law.

In addition to above principles the spin-off needs to be carefully planned and executed as smoothly as possible in order to avoid unnecessary disruption of service. The termination of the MD operation will be harmonized with the commencement of service of the new entity.

Finally the organization of the new entity including its set-up, systems and procedures will be structured along the criteria of transparency, effectiveness, efficiency as well as good governance of decisions and operations.

C. Legal Considerations

6. **Transformation Restrictions⁶:** As part of the UN, UNRWA is able – subject to its mandate and internal regulatory framework – to enter into relevant contracts for the extraction of its microfinance operations, including disposal of its microfinance assets to a third party. There are, however, limits to the options for a transformation. These limits are

⁶ From: “Analysis of UNRWA’s capacity to transform its microfinance operation under its mandate and pursuant to UN law and practice“, DLA dd. 21 December 2010

set out in the contemporary UN practice and are based on the character of the UN, privilege and immunities, and the status of UN staff members as international civil servants:

- i. UNRWA cannot be a shareholder in, or a member of an entity incorporated or established under national law, whether a company, institute, foundation or trust. It could however enter into cooperative arrangements with the entity;
- ii. UNRWA cannot enter into a joint venture with an entity or individual where the joint venture is regulated by local law;
- iii. It may not be possible to nominate or appoint an UNRWA staff member to serve as director, trustee or other role on the board of directors of the new entity.

7. **Transformation through a Spin-Off:** The above restrictions reduce UNRWA's options to transform its microfinance operations significantly. The desired transformation of UNRWA's microfinance operations into a separate and independent microfinance operation **is only possible through a full spin-off from UNRWA**. Such spin-off must be complete in terms of legal status, finance (equity or debt), corporate governance, management as well as institution building and staffing. Contrary to other microfinance transformations, UNRWA must not have any financial or governance relationship with the new entity. Upon completion of the spin-off, UNRWA will have no formal ties whatsoever with the new entity.

8. **Spin-Off through Sale or Donation?** Financial Regulation 5.4 provides, that the "Commissioner General may authorize the disposal, by sale or otherwise, of supplies or other assets found to be surplus or unusable, but shall establish appropriate procedures of disposal to ensure that the interests of the Agency are protected". Thus, the envisaged spin-off could take place either by sale or by donation to a third party. The Regulation also allows flexibility over the sale to a for-profit party.

The sale option preconditions include: **(i) the existence of a buyer** (whether for-profit or non-profit) interested in taking over the UNRWA microfinance programme; **(ii) the financial capability** of such buyer to purchase UNRWA's microfinance assets and on-going concern; **(iii) the technical and institutional competence** to manage the UNRWA microfinance operations; **(iv) acceptable reputation** as only a well reputed buyer may be trusted to properly honour all declared commitments after the execution of the sale; and especially: **(v) the buyer's clear and binding commitment** to continue the microfinance operations along UNRWA's programme mission and principles.

It is doubtful, whether such candidates exist, who fulfils the above preconditions satisfactorily. A public tender might be the most efficient tool to verify the viability of the sale option. But even if equally eligible and interested investors were identified, doubts will remain on whether such candidates will unconditionally and reliably commit to the guiding principles as laid out above (see Point 5):

- I. Arguably, UNRWA could sign a Memorandum of Understanding (MoU) with a selected buyer on adherence to above guiding principles. But no trustworthy assurance can be given on whether and how the buyer will respect such commitment. Understandably the buyer will adapt the UNRWA programme to their institutional and operating environment and as such might gradually or significantly drift from the UNRWA mission. It is hardly conceivable that UNRWA will seek legal justice for such misuse of its sold programme.

- II. In a worst case scenario, the UNRWA programme could even be subjected to asset stripping and full termination. Though not particularly relevant in the microfinance industry, the international experience with mergers and acquisitions includes several cases where the purchased entity was either completely absorbed by the buyer's organization or thereafter dissolved. There would be no hedging of the UNRWA programme in case of a sale.
- III. Additionally, in case of sale, the preparedness of the MD staff to depart from UNRWA and accept transfer to a buyer (whether for-profit or non-profit) may be doubted for two reasons: **(i) Typically the MD staff feels particularly safe in its UN environment.** Unsurprisingly, they will be very worried about their fate outside the UN and as such need special comfort and motivation to accept their departure from the UN; **(ii) the transferred MD staff will expect to remain on par with their UNRWA salary scheme** including compensation for income tax obligations. It is hardly doubtful that the buyer will accept adopting the – probably much higher – UNRWA salary scheme for the MD staff while using his own salary scheme for his other staff.

For these reasons and in order to ensure UNRWA's liberty to select the most suitable legal and institutional set-up for the envisaged spin-off without compromising on potential conditions of a buyer, **it is recommended to spin-off the microfinance programme through a donation to a non-profit organization** to be established and organized for this purpose. The UNRWA funds have been used to support the development of microfinance in UNRWA's areas of operations for the benefit of its target group and the spin-off to such non-profit organization will continue to maintain this objective.

9. ***Donation to NGO or Foundation?*** Typically a non-profit organization could be a non-government organization (NGO) or a Foundation. Exceptionally, some jurisdictions also allow the establishment of a non-profit private company. The choice of the most suitable type depends on the functions, which the envisaged entity is expected to perform. NGOs are usually characterized by following institutional and governance weaknesses:

- I. In some countries NGOs are subject to the **regulation and supervision of the national Ministry of Social Affairs, Ministry of Interior** or similar ministries, which by definition lack competence on banking matters and as such usually aggravates the operations of a microfinance NGO;
- II. Given the common understanding that NGOs are primarily established for humanitarian reasons, they are often **only licensed for a restricted range of activity**. In particular, many jurisdictions prohibit NGOs from owning shares of for-profit companies. This would be detrimental for the UNRWA spin-off, because – as discussed further below – the envisaged non-profit organization will be expected to operate commercial subsidiaries;
- III. **The mission and purpose of an NGO as laid down in its statutes may be changed** subject to submitting a respective request to its supervisory authority. Hence a gradual or even complete drift from the UNRWA mission may not be excluded;
- IV. **NGOs are typically not fully recognized by commercial banks** and other financial institutions as sufficiently creditworthy, typically because of lack of ownership and inappropriate governance. This might hinder the transformed

UNRWA programme from accessing capital, which is one of the prime purposes for the spin-off.

10. **Charitable Foundation or Private Foundation?** A charitable Foundation is a legal categorization of non-profit organizations that will typically either donate funds and support to other organizations, or provide the source of funding for its own non-profit purposes. A private Foundation is a non-government legal entity that is organized either as a non-profit corporation or as a charitable trust. A private foundation is generally founded and capitalized from a single source (such as an individual, a family or a group of individuals) and managed by its own trustees and directors. Its purpose covers philanthropy (social aid, educational, religious or other charitable activities primarily through grant financing) or also a legal economic operation. Subject to its jurisdiction, a private foundation could be tax exempt.

Unlike a charitable Foundation, a private Foundation does not generally solicit funds from the public. Contrary to an NGO, a foundation's purpose and mission is traditionally very difficult to change.

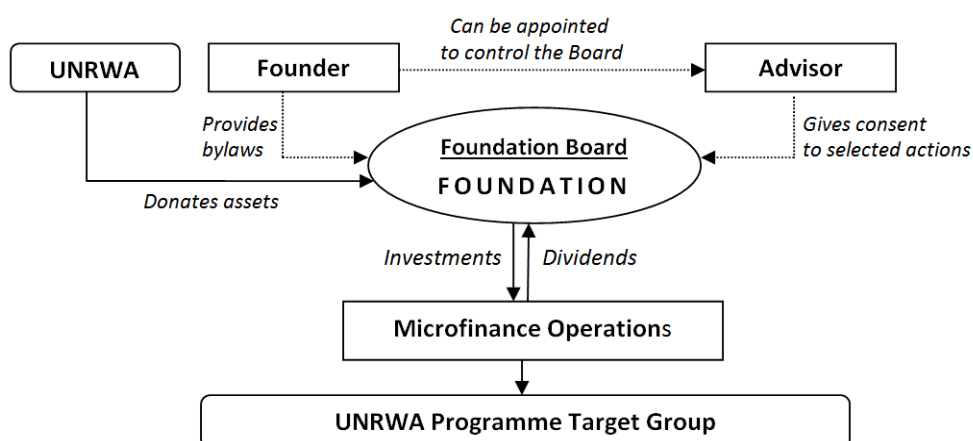
One of the characteristics of the legal entities existing under the status of "Foundations" is a wide diversity of structures and purposes. Nevertheless, there are some common structural elements that are the first observed under legal scrutiny or classification:

- Legal requirements for establishment;
- Purpose of the Foundation;
- Economic activity;
- Supervision and management provisions;
- Accountability and auditing provisions;
- Provisions for the amendment of the statutes or articles of incorporation;
- Provisions for the dissolution of the entity;
- Tax status of corporate and private donors;
- Tax status of the Foundation.

Some of the above must be, in most jurisdictions, expressed in the establishment document. Others may be provided by the supervisory authority at each particular jurisdiction.

11. **Donation to a Private Foundation.** In conclusion, it is recommended to spin-off the UNRWA microfinance operations through a donation to a Foundation. The type of a **private Foundation is considered applicable for the purpose of the UNRWA spin-off and donation.**

The proposed private Foundation is to be established for the sole purpose of the envisaged spin-off and receipt of the UNRWA donation. The most suitable jurisdiction (in terms of establishment requirements, operation procedures and costs) for the Foundation needs yet to be determined through a legal analysis, which will shortlist a number of potentially eligible jurisdictions and address all relevant governance, organizational, management and cost factors. Respective terms of reference have already been prepared. Regardless of its ultimate jurisdiction the Foundation to be established will be exclusively committed by its charter to the UNRWA mission and the above guiding principles. Any profits derived from its finance operations will be used for covering its costs and otherwise re-injected in its microfinance operations either for funding its portfolio growth or enhancing its institution and capacity building. The proposed foundation structure could be as follows:



The “Advisor” could be a single person or a committee voluntarily appointed by the Founder to provide strategic guidance to the Foundation’s Board and monitor the Board’s adherence to the Foundation’s statutes. The “Advisor” may additionally be entrusted with the power to give consent to selected and pre-defined Foundation activities considered to be of special importance.

Notice: The recommended choice of a Foundation relates exclusively to the legal recipient of the UNRWA donation. The envisaged subsidiaries of the Foundation, as further discussed below, are proposed to have the status of commercial legal entities.

12. **Governance of Foundation:** The size, composition and qualification of the Board of Directors of the Foundation will primarily follow the relevant regulations of the selected jurisdiction. The eligibility criteria for a Board member should be guided by the fit and proper rules, which are more or less adopted globally. For the purpose of the UNRWA programme, eligible Board members should preferably (i) feel **committed to the UNRWA mission** and business guidelines; (ii) be **familiar with the enabling environment** of the UNRWA countries; (iii) have sufficient **competence in banking operations** for small businesses and low-income people; (iv) offer **links to other relevant stakeholders**; and of course (v) enjoy **impeccable reputation** personally and professionally.

For ease of business, the members of the **Foundation board could initially also be members of the Foundation’s proposed subsidiary** (see Section D: Holding or Regional MFI) provided full compliance with relevant regulations. This should represent the simplest solution as long as such subsidiary is fully owned by the Foundation.

The selection of the **initial members to the Board of Directors will take place in close coordination with UNRWA**. It would be helpful to identify and involve the initial members at an early stage to ensure consensus. Their official nomination and appointment will take place through the initiators of the Foundations (see Section G: “Catalytic Function of the Technical Assistant”).

The appointment of an Advisor (or Advisory Committee) as outlined in above chart is understood to be voluntary. Therefore such a body is not assumed to be governed by national law and hence may present an **eligible opportunity for UNRWA membership** to remain indirectly involved and actively monitor the Foundation’s adherence to the UNRWA programme mission.

13. **Strategic Partnerships:** An affiliation of the Foundation with likeminded stakeholders is strongly recommended to facilitate further business growth and institutional development of the transformed entity. Prominent stakeholders would not only contribute

financially (equity/loans), but would also add value by enhancing the reputation of the new entity and contributing to sector experience, good governance and further technical assistance for capacity building.

- I. **Move Alone First.** Notably, it is not necessary to search and commit investors prior to executing the spin-off. Such attempt would risk substantial delays in view of additional time required by UNRWA for producing a comprehensive business plan, running road shows to identifying likeminded investors, awaiting the internal process of investor approvals and going through the lengthy phase of negotiating and executing a shareholder agreement until subscription and payment for shares. **Instead it should be sufficient to structure the envisaged spin-off in such way that keeps the door open to institutional investors** to become shareholders of the microfinance operations as and when the new entity embarks on an expansion strategy.

Thanks to sufficient funds and privileged access to technical assistance funds the UNRWA programme can afford moving forward with the spin-off without the financial support of investors. By the end of 2013 the UNRWA programme has cash availability of approximately USD 2 million, subject to a satisfactory settlement of the OFID trust fund, which could be used for spin-off preparations.

- II. **Keep Stakeholders Informed and Interested.** Once the new organization is well established and operating it will embark on a growth strategy that most probably requires additional funds. The typically lengthy process of identifying and committing eligible investors would be expedited if potential candidates were involved from the outset. **It is recommended to pre-establish links to likeminded stakeholders, solicit their interest and keep them informed on the spin-off progress.** This should facilitate their financial inclusion once the microfinance operations are set to embark on a growth strategy. Notably, the envisaged spin-off will likely cause substantial public attention (because of its uniqueness and its region), which most certainly will attract the interest of investors.

14. **For-Profit Subsidiaries for Strategic Partnerships:**⁷ Even though being likeminded, eligible candidates will nevertheless have a vested interest in profit sharing and at some point in time will also wish to exit and retrieve their monies hoping even for a capital gain. As such they are usually reluctant to contribute equity capital to a Foundation, since the Foundation will neither distribute profits (other than for its own microfinance purposes) nor could it return equity investments.

Therefore the envisaged Foundation alone will not suffice for attracting strategic shareholders. Instead the **Foundation needs to create one (or more) subsidiaries for accommodating interested investors** and where the Foundation and the designated investors will become joint shareholders. The Foundation will contribute the received UNRWA donation as a mix of in-kind and cash investment in the equity of the subsidiary in return for shares. The microfinance operations will be carried out not by the Foundation but by the subsidiaries. In turn, the Foundation's function will be reduced to just being a shareholder of its subsidiaries.

The subsidiaries should preferably be established as for profit companies in order to be sufficiently attractive for likeminded investors. A microfinance subsidiary requires a strong capital base to absorb unexpected shocks as well as to leverage additional debt for

⁷ Eligible candidates for a strategic partnership could be multilateral organizations like IFC, EBRD, bilateral organizations like SECO, SDC, KfW or private organizations with a development focus like Blue Orchard.

further growth. As already stated above even development finance institutions such as KfW, IFC, and EBRD would not contribute equity to non-profit companies owing to non-disbursement of dividends and aggravated chances for exit. Without a strong capital base, a non-profit company will be unable to reliably and continuously secure loans for its business growth.

The subsidiaries will have the status of a private commercial company; its alternative types (holding, regional or national finance institutions) will be discussed in Section D. Notably, the inclusion of a private limited liability company as subsidiary offers additional regulatory advantage, since the relevant regulatory authorities usually accept such legal status for licensing a non-bank financial institution or also a commercial bank. It is doubtful, whether the legal type of a foundation equally qualifies for such licenses.

15. **Can a Non-Profit Foundation run a For-Profit Subsidiary?** Certainly, yes! The term non-profit does not necessarily imply only charity business and grant distribution. Even though the prime purpose of a foundation may typically not be the generation and maximization of profits, yet foundations require the constant generation of sufficient cash flow to continuing their business. The categorization as non-profit primarily relates to the use of the profits earned, which under all circumstances must not be distributed to whoever established the foundation or any other stakeholder but should always be spent on the foundation's mission and purpose (hence covering its costs and re-investment in its microfinance operations).

D. Alternative Corporate Structures

16. This Section looks at the possible models of transformation and discusses whether they are acceptable in terms of local law but also in social, regulatory and political terms, free of conflict of interest (or the appearance of conflict of interest) and also suitable for admitting designated strategic stakeholders as shareholders in the alternative models.

17. **Basic Concept:** As stated above, the planned spin-off will include a transfer of the UNRWA microfinance assets, i.e. in particular the loan portfolio in addition to some tangible and intangible assets. The asset transfer will be accompanied by a transfer of the staff currently employed in the MD. Regardless of the alternative corporate structures to be discussed in this Section, all alternatives will adopt following transfer sequence:

- a) The **UNRWA microfinance assets will be transferred by donation** to a newly established private Foundation;
- b) The **Foundation will invest these assets through a mix of cash and in-kind contribution** in a subsidiary (or subsidiaries) all of which having the status of a for-profit company;
- c) **Alternative Models:** Depending on the regulatory requirements in each of the jurisdictions, three alternative models are conceivable:
 - i. **Direct establishment of three MFIs:** The Foundation directly establishes separate national MFIs in Palestine, Jordan and Syria. Each will be structured as a separate legal entity and will operate its own branch network;
 - ii. **Regional Financial Institution:** The Foundation establishes a regional financial institution which opens a regional branch network in Palestine,

Jordan and Syria. Each country branch network will be operated as a national profit centre;

- iii. **Holding:** The Foundation establishes a holding, **which in turn owns three national MFIs** in Palestine, Jordan and Syria. Each will be structured as a separate legal entity and will operate its own branch network.

The three models are further described and analyzed below.

- d) **Compliance with the UNRWA Mission and Principles:** The founding documents for each of the Foundation and its subsidiaries across all proposed alternative models will embody the mission and principles of the UNRWA programme and as such ensure that sufficient protection is provided to the UNRWA target group of Palestine refugees and women. Such founding documents encompass always the bylaws (charter/statutes) and occasionally also the shareholder agreement(s) depending on whether or not an investor is admitted.

The shareholders agreements will include a binding covenant to all designated investors across all subsidiaries to accept and comply with the UNRWA mission and principles.

Notably, all relevant founding documents shall be finalized and be available prior to the execution of the donation. The authorization of the donation shall be contingent on UNRWA's acceptance of these founding documents in form and content.

- e) **Management and Staffing of the Subsidiaries:** The MD staff to be transferred from UNRWA and its management will be deployed in the subsidiaries according to each of the three alternative models (see below).

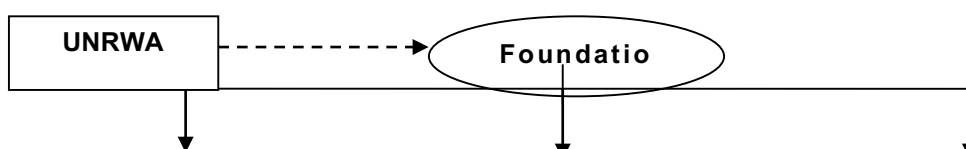
In all cases the transferred staff will be governed by a human resources policy tailored to the requirements of a stand-alone microfinance operation but also offering the staff necessary financial (salary scheme, bonuses, indemnities) and non-financial (training) motivation for departing from the UN organization.

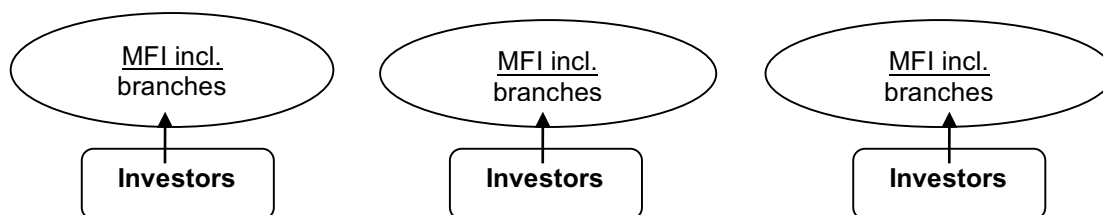
- f) **Management of the Foundation:** Notably, none of the MD staff will be required at the Foundation. The Foundation functions only as shareholder and as such does not need an own organization. As illustrated above the Foundation will be governed by its Board and could be **managed by a trustee** (see Section G: "Catalytic Function of the Technical Assistant").

18. Alternative 1: Foundation and Three National MFIs

Concept: This alternative considers a direct investment of the Foundation in three national MFIs, i.e. without the abovementioned insertion of an intermediary. Here the Foundation establishes a national microfinance institution including branches in each of the three jurisdictions (Palestine, Jordan, Syria). Each national MFI will be structured, capitalized and licensed according to the company, microfinance and/or bank laws of its jurisdiction. Each MFI will have its own head office and branch network.

Initially each national MFI will be fully owned by the Foundation. At a subsequent stage, each of the national MFIs may increase its capital by inviting new investors. The investors could be the same at all three MFIs but could also be different. Equally their shareholding structure could differ and change over time.





Staffing: Each of the MFI will have an own head office and a branch network. Therefore the MD staff of the head office in Jerusalem will be distributed over the separate head offices of each of the three MFIs. The field staff of the MD will be deployed in the respective branches.

Accounting: Profits are earned by the national MFIs. Each MFI will produce its own financial statement including the declaration of profits or losses. The distributable profit is paid out by each of the national MFIs directly to the Foundation – either all or in proportion to its shareholding.⁸

Advantages	Disadvantages
+ Only a two tier structure.	- No streamlined regional approach.
+ Investors enjoy choice of one or more MFIs.	- Three MFIs instead of one.
+ No risk sharing of all MFIs; but also no diversification.	- Each MFI needs its own governance and management.
+ Each MFI can be fully tailored to its operating environment.	- Investors and financiers need to deal with each national MFI separately.
+ Each MFI may be upgraded as prompted by market demand and requirements.	- Each MFI needs its own institution building, incl. head office, systems and procedures.
	- MD head office to be split in three offices.
	- No or aggravated mobilization of synergy potential.

19. Alternative 2: Foundation, Regional MFI with Three National Branch Networks

Concept: The Foundation establishes a single regional microfinance institution (Reg. MFI) similar to other regionally active organizations (e.g. Arab Bank, HSBC). As in the case of the Foundation, the Reg. MFI jurisdiction needs to be determined through a legal analysis of short-listed suitable alternatives.

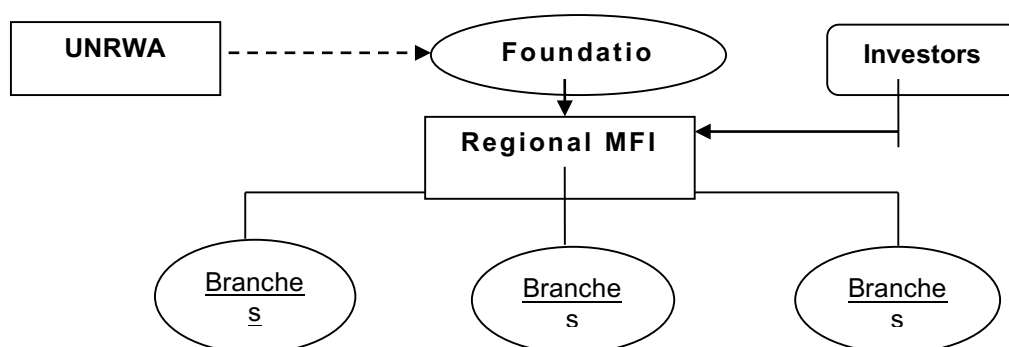
The Reg. MFI will have its focus on the MENA region. It will establish a national branch network in each of the three countries (Palestine, Jordan and Syria). Each of the national branch networks will be licensed subject to the laws and regulations of its jurisdiction. Each branch network will be collectively accounted internally as a separate profit centre.

⁸ Distributable profit is the portion of a company's accumulated profits that is available for dividend distribution, i.e. net of realized losses and net of legal and other reserves.

The Reg. MFI head office will offer full back office and administrative support to its branches. At a subsequent stage the Reg. MFI may increase its capital by inviting new investors.

Staffing: The MD staff of the head office in Jerusalem will be transferred to the head office of the Reg. MFI; the MD field staff will be deployed in its branch networks.

Accounting: Profits are earned by the Reg. MFI. The Reg. MFI including its three national branch networks will be accounted as one single company. The Reg. MFI will produce one financial statement on all its regional activities, which will also include a declaration of profits or losses. The distributable profit is paid out by the Reg. MFI to the Foundation – either all or in proportion to the Foundation’s shares in the Reg. MFI.



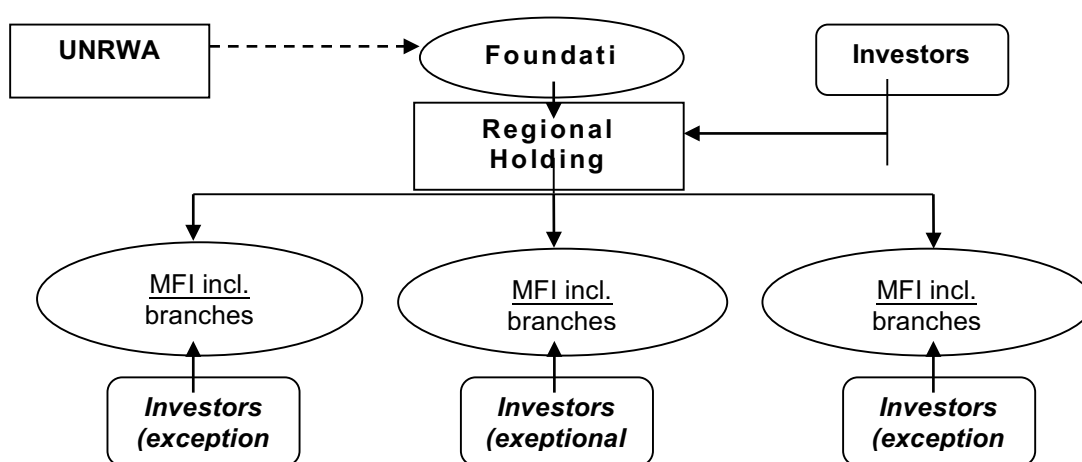
Advantages	Disadvantages
+ Only a two tier structure.	- Investors cannot choose between countries.
+ Investors and financiers deal only with Reg. MFI (i.e. not on any of the 3 national levels).	- The institution building of a Reg. MFI is more complex than smaller domestic MFIs.
+ Enhanced efficiency through administrative support of a single back office.	- Jurisdiction of Reg. MFI yet to be identified (may be costly & labour intensive).
+ Synergy potential can be mobilized (for policies, systems, staffing, funding).	
+ A focused & streamlined regional approach.	

20. **Alternative 3: Foundation, Regional Holding with Three National MFIs**

Concept: It is here assumed that the jurisdictions of Jordan, Palestine and Syria will only licence a domestic MFI and not just a branch of a Reg. MFI. Therefore, Alternative 3 foresees the establishment of a Regional Holding with a national MFI in each of the three jurisdictions. Each of the national MFIs will be licensed and will operate a branch network in accordance with the regulations of its respective jurisdiction. Just like the Reg. MFI, the Holding will offer full back office and administrative support to its subsidiaries. Notably, the licensing requirements and procedures in each of the three jurisdictions still need to be established and clarified through legal analyses.

Staffing: The MD staff of the head office will be transferred to the Holding and the MD field staff will be deployed in its national MFIs including its branches.

Accounting: Profits are earned by the national MFIs. Each MFI will produce its own financial statement including the declaration of profits or losses. The distributable profit is paid out by each of the national MFIs to the Holding – either all or in proportion to the Holding’s shares in the MFIs. In a subsequent step the balance sheets of the holding and the national MFIs will be consolidated into one financial statement. The resultant distributable profit is paid out by the Holding to the Foundation – either all or in proportion to the Foundation’s shares in the Holding.



Advantages	Disadvantages
+ Investors and financiers deal mainly with the Holding (i.e. not on any of the other levels).	- A three tier structure, which in turn prompts more complex organization and governance.
+ Investors and financiers may exceptionally choose between the MFIs.	- Four separate organizations: a Holding and three national MFIs.
+ Enhanced efficiency through back office and administration support by the Holding.	- Each MFI needs its own governance & management – but could be harmonized.
+ Synergy potential can be mobilized (for policies, systems, staffing, funding).	- The organization of a national MFI is more complex than a national branch network.
+ A focused and streamlined regional approach.	- Jurisdiction of Holding yet to be identified (may be costly and labour intensive).

21. **Conclusion:** Obviously none of above Alternatives 1 – 3 is free from disadvantages. Yet, if we consider a streamlined and focused regional approach and a unified back office support to be of paramount importance, then **Alternative 1 (“Foundation and Domestic MFIs”)** must be excluded. This Alternative should also be

the least desirable from an institutional investor's point of view. Even though some investors may take a particular interest in one of the three countries (Palestine, Jordan, Syria), yet the most likely – and also most desirable – eligible investors will opt for a regional investment rather than for a small national project. Notably, such institutional investors tend to shy away from small investments, which incur high administrative transaction costs and promise only a small return in absolute figures. Not to forget: it is particularly the regional nature of UNRWA's microfinance operations that distinguishes it from other traditional microfinance projects, which in turn will constitute the spin-off as an especially attractive investment opportunity.

Alternatives 2 and 3 compare as follows:

- I. Alternatives 2 and 3 **equally comply with the guiding principles for the UNRWA** programme spin-off and are also well suited to encourage stakeholders to contribute equity and funds to support the success of the transformation.
- II. Alternatives 2 and 3 are quite **similar in terms of their overall structures** and the interaction between the Regional MFI and its branches or the Regional Holding and its subsidiary MFIs.
- III. In both cases, the branch network per country (Alternative 2) or the national MFIs (Alternative 3) **will be accounted as separate profit centres and will be fully consolidated** in the financial statements of the mother company.
- IV. **Alternative 2 enjoys the comparative advantage of being less complex** (only a two tier structure), which is less expensive and requires less governance. Only one Board of Directors and only one audited financial statement would be required for the Reg. MFI.
- V. **Alternative 3 requires four Boards of Directors, four accounts and four audited financial statements.** Any expansion into another MENA country necessitates additional Boards, accounts and audited statements. Equally, each of the Holding and its subsidiaries need separate company founding documents and registration procedures.
- VI. **Conversely, Alternative 3 offers more flexibility for investors or financiers,** who may be interested in promoting a particular country, or on the contrary wish to avoid another (e.g. Gaza).

In conclusion, **Alternative 2 appears to offer overall the best choice** especially in terms of comparative simplicity of organization and therefore would be less expensive to set-up, operate and control. Yet it is unclear, whether such Reg. MFI model would be legally feasible, or whether each of the jurisdictions in Palestine, Jordan and Syria will only licence a formal local MFI and not just a branch of a regional MFI. Ultimately, the choice between Alternatives 2 and 3 will be based on the results and recommendations of the pending legal analyses.

22. **Consider an ESOP Scheme?** Irrespective of the alternative model finally selected the inclusion of an employee stock ownership plan (ESOP) may also prove to be an effective tool for keeping the staff motivated and committed to the company. Several transformations in the microfinance sector involved an ESOP scheme. The structure of a viable ESOP in the case of the UNRWA spin-off depends on the applicable laws and regulations as well as on the ultimately selected legal setup and structure of the spin-off.

E. Organizational Set-Up

23. The previous Section elaborated alternative models combining a foundation with a holding, a regional MFI, national MFIs and national branch networks. Once the overall model is selected the detailed institutional organization of the transformed entity needs to be considered. Basically any organization is characterized by its units and processes. The suitability and interaction of both determine the organization's quality. This Section offers basic guidelines for organizing the transformed entity. The detailed planning will be carried out following the result of the pending legal analysis.

24. **Paramount Principles of Transparency and Efficiency:** To date UNRWA microfinance activities are organized as a programme fully integrated in the overall UNRWA administration. Upon its spin-off the microfinance operations need to be based on an institutional organization that qualifies as a stand-alone commercial entity including:

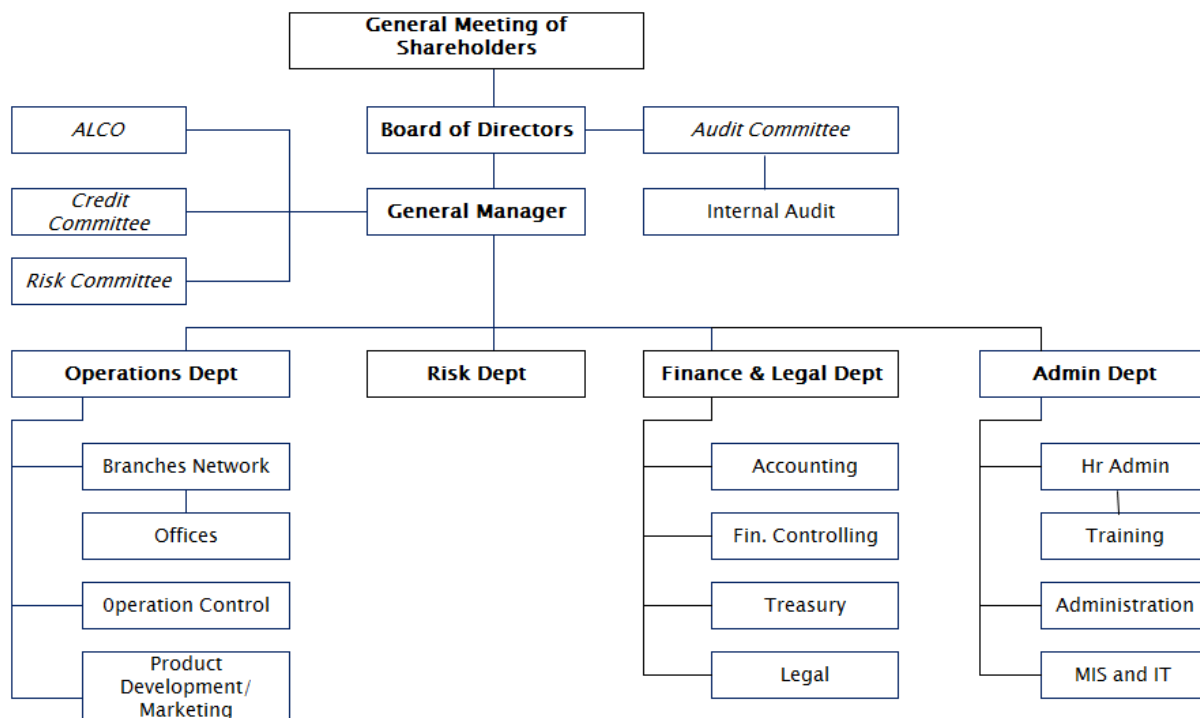
- I. proper governance;
- II. a commercially focused institutional set-up combined with;
- III. a set of clear and fair systems and procedures, which altogether ensure best possible efficiency, effectiveness and transparency of operations;
- IV. a set of clear strategies, policies and operation directives in binding compliance with the UNRWA mission and guiding principles as defined above (see Point 5).

On the other hand, the ultimate organization to be selected for the spin-off should adopt as much as possible of the existing and well established units, system and procedures in order to ensure a smooth transition from the UNRWA administration to a stand-alone entity.

25. **General Guidelines for Organization:** the Chart below is provided only as an example to illustrate basic principles of a proper organization of a private company in general and a formal financial institution in particular. The corporate governance consists of a two tier structure, namely the General Meeting of Shareholders and the Board of Directors. The Board members are nominated by the General Assembly and are accountable for the overall development of the company.

The Board typically delegates the task of the day to day company operations to either a General Manager, or – depending on the size of the company – to a Management Board. The Board's principle task is to control the management and to provide strategic guidance. In the illustrative chart, the company organization is broken down into four major departments, each reporting directly to the General Manager. Note that having too many departments reporting directly to the General Manager is counterproductive, as this tends to overburden the General Manager and increases the overall corporate dependence on a single person.

Each department including its units needs to be furnished with well documented policies and standard operating procedures. The number of the major departments and the units differ according to the size and nature of a company's operation. Yet in all cases the Internal Audit unit enjoys a unique status as it reports directly to the Audit Committee, which is a sub-committee of the Board of Directors.



The above chart may serve as a basic guide for the organization of the Regional MFI (Alternative 2) or of the Regional Holding (Alternative 3). In both cases the bulk of the overhead administration is concentrated here. The branches (Alternative 2) or the domestic MFIs (Alternative 3) will have a lean structure and will be exclusively focused on field operations.

26. **Organization of a Financial Institution:** Even though each financial organization enjoys its very own set-up, by experience the organizational separation of (i) operations, (ii) risk (i.e. for credit, market and operation) and (iii) finance has consistently proven to be the most suitable form for effectiveness of operations and transparency of governance. Furthermore, the management of a financial institution is supported by several types of committees, the most prominent are for asset and liability control (ALCO), credit and risk. The composition of each committee differs according to the committee tasks. In case of a decentralized credit approval policy, credit committees could be operated on branch, regional and head office level.

Interestingly, financial institutions typically start with a nucleus organization, which evolves over time as and when the institutions expand. Not uncommon, organizational changes or expansions are tailored around key staff and as such may no longer secure the required levels of transparency and efficiency. In the context of the spin-off, UNRWA now has the chance to establish an organizational set-up from the outset that is best suited for the envisaged expansion of the microfinance operations in terms of clarity of hierarchy, tasks and responsibilities of each staff member.

F. Basic Action Plan

The previous Sections discussed guidelines, principles, restrictions and alternative institutional models for the transformation of the UNRWA programme. The following Section deals with the planning and execution of the transformation. It provides an overview on the various phases of extracting the UNRWA programme and re-establishing it as an independent corporate structure and elaborates on the tasks related to each phase.

27. **The Spin-off and Transformation** process will encompass a complex set of tasks to be performed and will typically cover following pillars, which depending on their nature will be executed subsequently or in parallel:

- a. **Selection of corporate structure;**
- b. **Institution and capacity building;**
- c. **Establishment, registration, licensing of the corporate structure;**
- d. **Planning/Executing the transfer of staff and assets;**
- e. **Start of operations and leverage for growth (equity/debt).**

A proposed initial work-chart is annexed. The duration of the spin-off until the full commencement of operation depends on many interconnected factors and hence is difficult to predict. Notably, the detailed planning of the transformation in terms of objectives, milestones and time targets will follow once the decision on the institutional alternative has been taken based on the results of the pending legal research. Yet provided there are no significant external shocks the spin-off process should take around 1.5 to 2 years to complete.⁹

Recommended Spin-Off Support Measures:

In order to facilitate the process and ensure a maximum level of consensus the following support measures are proposed for the interim phase:

28. **Establish a Spin-Off Committee:** The spin-off will cover all aspects of UNRWA's microfinance operations including all overhead services provided by the general UNRWA administration. The spin-off needs to be carefully planned and skilfully carried out. This will be a collective effort that requires close cooperation and continued consensus. It is therefore advisable to establish an internal committee for the spin-off with clear tasks, responsibilities and timelines. The committee members will expectedly take a leading position after the spin-off. The members must also qualify as internal champions, who inform the staff regularly on the progress and – most important – keep the staff motivated and excited about the prospects of the spin-off.

29. **Nominate a Spin-Off Key Person:** The spin-off process is lengthy and laborious. All persons engaged in the process will need to perform their spin-off related tasks on top of their other daily business. The risk of reduced attention to the strategic spin-off goal because of more pressing short term deadlines of other responsibilities will keep looming. It is therefore advisable to nominate a suitable committee member to be in charge of the spin-off and to release that person from his/her regular duties accordingly. Should this not

⁹ A detailed work plan has been worked out by Shore Bank International (2010). Even though its proposed model will not be completely adopted, yet a significant part of its work planning could be used here as well.

be feasible, then hiring an external person – possibly on intermittent basis – should be alternatively considered.

30. **Secure Continued External/Internal Legal Advice:** The spin-off requires a series of decisions of legal nature on substantial issues like the legal status and structure of the envisaged new entity (or entities), staff issues, registrations, transfer of assets and opening up to new shareholders. Proper legal advice will be of the essence, especially since legal errors are usually very difficult and/or costly to rectify. In view of the various jurisdictions involved, it will be necessary to collaborate with a number of law offices. The **UNRWA DLA** should be closely involved throughout the spin-off and transformation process and act as the internal counterpart to the external legal advisors. This includes *inter alia* reviewing legal terms of reference, controlling the assigned law firms, accepting external legal analyses, reviewing founding documents of the selected corporate structure including also MoU and shareholders and subscription agreements, monitoring the registration and licensing processes and checking conditions precedent for executing the donation. To ensure continuity within this process it is recommended that DLA appoint a key focal point for this work.

31. **Keep Staff informed on Progress:** Significant institutional changes bear the risk of staff anxiety and frustration, which is particularly relevant in cases of transformation. It is of paramount importance to keep staff regularly informed on the progress and to combat misleading rumours.

32. **Design and Run an Awareness Campaign:** Customers react differently to a microfinance transformation. Some may even reject changing from UNRWA as a lender to a stand-alone commercial entity. In order not to risk losing good customers through the spin-off it would be helpful to alert the customers and other stakeholders prior to the spin-off and give them comfort that the new entity will continue on the same business principles and even improve its outreach and services to its customers.

THE PLANNING PHASE

33. **Internal Considerations:** UNRWA has meanwhile sanctioned three Internal Management Group sessions on (i) human resources, (ii) legal issues; and (iii) asset valuation to work on the internal side of the transformation in order to enable the Agency to facilitate the eventual extraction of the MD from UNRWA. Issues to be considered relate *inter alia* to MD stakeholders (e.g. Palestine refugees, MD clients, host authorities (including financial regulatory authorities), microfinance competitors, donors (MD/Agency), MD Advisory Board, Advisory Commission, UNBOA and UNGA, mandate issues, politics, PR, donors, current loan agreements and guarantees, disposal of a valuable asset, potential disposal of other working assets that support the MD function within the Agency, staffing/HR (including union issues, employment contracts, pension and other entitlements), and operational issues. This list is not necessarily exhaustive.

34. **Preparation:** The envisaged spin-off requires complex preparation in terms of legal analyses for choosing the most suitable corporate structure of the spin-off, followed by organizational planning (i.e. set up of departments and units), process planning (i.e.

policies, systems and procedures) and capacity building. During this phase also strategic corporate planning and long-term budgeting of the new entity are also necessary in order to validate the business potential and ensure the commercial sustainability of the new entity after the spin-off.

35. **Identification of the Key Staff for the Selected Legal Structure:** Assumingly the new corporate structure will not require much more or different staff, than is already employed at UNRWA's microfinance programme. This should in particular also relate to the designated key staff of the envisaged holding or Reg. MFI. Yet if new or additional key staff will be required, then it is important to get them on board as early as possible. Of special importance in this context are the designated general manager, the operations manager and the finance manager. These persons should be thoroughly involved in the spin-off plan and implementation in order to fully endorse its rationale, set-up and policy.

36. **Institution Building:** The selected corporate structure will determine the corporate layers to be considered ¹⁰and for each model the type and size of units (and sub-units) to be established. The extraction from the complex UNRWA organization will necessitate adjustments and/or expansions to the organization in order to secure its efficiency and operational capability also on a stand-alone basis. The UNRWA microfinance programme already enjoys a number of policies (e.g. credit, risk, HR, treasury etc.) and standard operating procedures (SOP) which are useful also for the transformed solution. These policies and SOP have to be reviewed and if needed re-tailored to the requirements of the new entity. Equally additional policies may have to be drafted and approved. This is typically a lengthy process, which typically involves several rounds of internal discussion until mutual consent is reached.

The spin-off also provides an ideal opportunity to check and rectify current organizational weaknesses. On the other hand, the spin-off should preserve the current organization of the UNRWA programme as much as possible, in order to make the transformation as smooth as possible.

37. **Capacity Building:** Typically, human resources constitute the major asset of (not only) a financial institution. The transformation to a commercial standalone finance institution will expose the staff to different or additional tasks and challenges. Therefore, any type of transformation requires systematic and thorough staff preparations and training, which should be planned at an early stage and ideally should commence even before the spin-off is carried out in order to ensure efficient and effective business operations from the outset.

38. **Preparation of Asset Transfer:** An inventory of the assets to be transferred will be established covering fixed assets and financial assets (loan portfolio and cash). Subject to regulatory requirements the assets value needs to be approved by the regulatory authority to qualify as in-kind equity contribution. The modalities of the transfer need to be determined including coverage of outstanding receivables. Particular attention will also be paid to the transfer of the IT/MIS and the migration of included data. The modalities planning will cover a multi-phase asset transfer: (i) from UNRWA to the Foundation; and

¹⁰ See Section D ("Alternative Corporate Structures"): Reg. MFI model (2 layers); Holding model (3 layers).

(ii) from the Foundation to the Reg. MFI or Holding. In case of a Holding a third transfer will follow: (iii) from the Holding to the national MFIs.

39. **Preparation of Staff Transfer:** The spin-off involves a reallocation of all or part of the UNRWA microfinance staff members to corresponding positions within the new corporate structure (head office & branches or holding & subsidiaries as the case may be). Typically each staff member will be anxious to know as early as possible where he/she will finally be deployed. The modalities of the staff transfer need to be established. This involves the final selection of staff to be transferred and the exact assignment of a staff member to a particular workplace. This in turn requires as a pre-requisite a detailed organizational set-up of the envisaged corporate structure and the acceptance of the assigned workplace by the respective staff member. Moreover a proper staff policy needs to be in place upfront including a viable scheme for salaries, bonuses and indemnities. The staff transfer should take place in full compliance with the respective labour laws and in coordination with the union in order to avoid frictions and/or disruptions.

40. **Commercial Viability of the Spin-Off:** The envisaged transformation is not a goal per se but only a measure – albeit a significant one – to secure the UNRWA programme sustainability and further growth. Therefore the institutional and operational growth and financial self-sufficiency potential needs to be substantiated by a proper business plan¹¹, which defines strategic long-term business targets based on verified market potentials and determines the necessary pre-requisites (institution building, staffing, branches, products, capital, funding) timeline and milestones for this purpose. The business plan will also be used to attract stakeholders.

41. **Visit Transformation Show Case:** Even though the transformation of UNRWA's microfinance programme is unique (see Point 2), it nevertheless should profit from lessons learnt from previous transformations. ACLEDA Bank (Phnom Penh/Cambodia) appears to be a very suitable show case for two particular reasons: (i) ACLEDA's transformation was supported by a UN organization (UNDP) and as such is familiar with UN principles and limitations; and (ii) ACLEDA Bank has meanwhile expanded regionally into Laos and Myanmar and as such enjoys valuable field experience in the organizational and institutional interaction between the mother company and its subsidiaries.

THE EXECUTION PHASE:

42. **Registration of the Legal Structure:** The foundation documents of the required legal entities (Foundation, Holding or Regional MFI, branches) will be finalized. The establishment process of the various entities is commenced by support of external law firms of the relevant jurisdictions. The establishment process will also include the

¹¹ A business plan typically outlines the planned development of an entity. It defines strategic goals (market share, sales, profitability within the given regulatory and operating environment and elaborates on institutional, operational and financial requirements to successfully execute its strategy including the definition of relevant milestones and success indicators. This also encompasses the definition of the target group and the marketing strategy for an effective outreach. A business plan concludes with a cash flow plan consisting of an estimate of investment requirements and finance needs, and a mid to long term projection of balance sheets and profit & loss accounts. This also includes a sensitivity analysis to cater for perceived success risks.

nomination and appointment of the members to the various Boards of Directors and the key management team at all entities of the corporate structure.

In view of restrictions on UNRWA's direct engagement in the establishment of the corporate structure it is advised to involve a third party in this process (see Section G: External Technical Assistance).

43. **Licensing:** The various entities need to be adequately capitalized and properly licensed. It is assumed that neither the Foundation nor the Holding will need to meet a minimum capital requirement. But the Reg. MFI (Alternative 2) or the national MFIs (Alternative 3) will need to be adequately capitalized in order to be licensed. Depending on regulations the branches may also need to meet defined specifications to be accepted by the relevant authority. In absence of available donor funds, the capital requirement would have to be covered by financial resources of the UNRWA programme. Hence the donation would first start with a cash transfer.

44. **Donating the Programme:** Upon being licensed the Reg. MFI (Alternative 2) or the national MFIs (Alternative 3) would be ready for operation. Now the ownership of the eligible MD assets will be transferred to the Foundation. Once booked they will be contributed as in-kind and cash investments in the equity of the Foundation's subsidiaries. Concomitantly the MD staff will be transferred to the Foundation's subsidiaries. It is advised not to execute all asset transfer in one shot but to start with the Palestine assets first followed by Jordan and thereafter by Syria. This would ease the complexity of the process and allows adopting lessons learnt on the subsequent transfer. However, it needs to be checked whether such phased-in donation and transfer is technically possible (this relates in particular to the MIS/IT and migration of business and staff data).

Needless to say, the efficiency and success of the execution process will be dependent on the scrutiny of the planning and preparation but also on the MD capability to effectively react to unscheduled developments.

THE OPERATING PHASE

45. **Initial Phase:** As proposed, the new entities will become operational in a consecutive process. Each will operate according to the prepared business plan. In addition the current annual budget of the UNRWA programme will be adopted and adjusted to the new institutional set-up. Especially during the first year of operation the management will be engaged in identifying and rectifying institutional and capacity obstacles, particularly if the new set-up will include new units or substantially changed units (e.g. internal audit, finance and risk). Management focus will also be put on further capacity building of its staff. Sufficient budgets need to be earmarked for training purposes, either through existing funds or procured donor support.

46. **Expansion Phase:** Subject to the successful conclusion of the transformation and the acceptably smooth operation of the new entities, the transformed programme will embark on its growth strategy as to be foreseen in the business plan. In preparation thereof the already established network of likeminded investors will be invited to subscribe to new shares and provide sufficient capital to fuel business development including the growth of the loan portfolio, the introduction of new finance products and the extended outreach to the UNRWA target group of Palestine refugees, women, youth and other proximate poor and marginal groups

G. External Technical Assistance

47. **Requirement for Technical Assistance during the Spin-Off Phase:** Above tasks and activities will absorb substantial human and capital resources, which UNRWA will probably not be able to mobilize and cover alone. Here comprehensive external technical support will be required in terms of advisory expertise along the whole spin-off process and addressing all institutional aspects of the microfinance programme relevant to the transformation. Expectedly a pool of short term consultants will be required, preferably to be led by a long-term intermittent team leader.

Replacement funding should also be sought for the procurement of such fixed assets, which had been provided by UNRWA and may no longer be used after the spin-off (e.g. transport facilities, office equipment, IT). A tentative technical assistance budget is annexed.

48. **Catalytic Function of the Technical Assistant:** As stated, UNRWA cannot be involved in the establishment, management or governance of any of the legal entities required for carrying out the spin-off and establishing it as an independent set of entities (Foundation, Holding, Reg. MFI, national MFIs). On the other hand and as described above, the proper existence of such entities is a principle pre-condition for exercising the donation and approving the staff transfer. These entities will also be required for executing all legal arrangements relevant to the spin-off and transformation (e.g. employment contracts with the transferred MD staff, purchase contracts for fixed assets, lease contracts for head office and branches, refurbishment orders, application for establishment and licensing of branches etc.).

Here the Technical Assistant could volunteer to act as a catalyst¹². They **could – based on an instructive MoU of UNRWA – establish a nucleus company, which at a later stage would be upgraded to the Holding or the Reg. MFI as the case may be**. Such nucleus company would constitute a valid legal entity for executing the abovementioned legal contracts. Once the Foundation is established and capitalized (through the UNRWA donation) it would assume ownership of the nucleus company and upgrade it institutionally and financially. As a catalyst, the Technical Assistant would ultimately withdraw from the nucleus company.

The Technical Assistant could also be instrumental by **submitting the application for the establishment of the Foundation**. Alternatively a **donor organization could undertake this task** in order to give more credibility to the Foundation. Such partner could for example be the **Swiss Development Corporation (SDC)**, which has a longer track record in supporting MFIs both institutionally and financially. Here UNRWA would sign a MoU with such a donor on the exact terms of the desired Foundation.

H. Summary of Recommendations

49. In summary following recommendations are submitted for approval:

¹² A catalyst is a substance that modifies and increases the rate of a chemical reaction without being consumed in the process. Here In the figurative sense: Someone who precipitates a process without being involved in or changed by the consequences.

1. Carry out the transformation of the UNRWA microfinance programme through a complete **spin-off of its related assets and staff** from UNRWA;
2. The ownership of the UNRWA microfinance assets will be transferred **to a private Foundation through a donation**;
3. In order to **accommodate institutional investors, the Foundation will establish a corporate structure** consisting of either (i) a regional microfinance institution with three national branch networks or as (ii) a Holding with three national MFIs. The ultimate choice will be based on the results and recommendations of a comprehensive legal analysis (in preparation).
4. UNRWA to decide, whether it is eligible and interested in **membership to an advisory committee** of the Foundation and/or the Holding/Reg. MFI.
5. The corporate structure will be capitalized by the Foundation through **a mix of cash and in-kind donation**.
6. Depending on the abovementioned ultimate choice the UNRWA programme staff will be transferred to the MFI head office and its domestic branches or to the holding and its domestic subsidiaries.
7. **Donor organizations to be requested to fund the necessary technical assistance** for capital expenditures and advisory services
8. Likeminded institutional investors will be invited to participate as shareholders **only after the spin-off and transformation is completed**.
9. **External technical assistance to be procured** to support the MD in planning and executing the spin-off and transformation process.
10. Technical assistant be requested to **initiate the establishment of the Foundation and to establish a nucleus company** to serve later as the regional MFI or as the Holding.